No. 82-1200 filed 1/17/83

IN THE

Supreme Court of the United States

October Term, 1982

DAILY INCOME FUND, INC. and
REICH & TANG, INC.

Petitioners,

v.

MARTIN FOX,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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January 14, 1983

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Question Presented for Review

Is a shareholder's derivative action under § 36(b) of the Investment Company Act of 1940 exempt from the director demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure?

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Petitioner, Daily Income Fund, Inc. ("the Fund") respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this proceeding on October 26, 1982.[1]

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1 Reich & Tang, Inc., the investment adviser to the Fund (and the other defendant in this action) supports this petition in all respects. Pursuant to Rule 28.1 of the Rules of this Court, the following is a list of all parent companies, subsidiaries (except wholly owned subsidiaries) and affiliates: the Fund—none; Reich & Tang, Inc.—August Associates and Centennial Associates.

Opinions Below

The opinion of the District Court (Hon. Kevin T. Duffy) is reported at 94 F.R.D. 94 (S.D.N.Y. 1982). The opinion of the Court of Appeals is reported at 692 F.2d 250 (2d Cir. 1982). Both are reproduced in the appendix to this petition.[2]

Jurisdiction

The judgment of the Court of Appeals was entered on October 26, 1982. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

Statutes Involved

The statutes and rules involved are Section 36(b) of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. § 80a-35(b) and Rule 23.1 of the Federal Rules of Civil Procedure ("Rule 23.1").

Statement of the Case

Respondent, a minority shareholder of the Fund, a money market fund, instituted a derivative action under § 36(b) of the ICA against Reich & Tang, Inc. ("the Adviser"), the investment adviser to the Fund, to recover allegedly excessive advisory fees. The Fund was also named as a defendant.

The Board of Directors of the Fund consists of five individuals: three unaffiliated directors and two who are

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2 All page references to the appendix are in parentheses and are followed by the letter "a."

affiliated with the Adviser. Thus, a majority of the Board of Directors of the Fund is unaffiliated.[3]

No demand was made by respondent on the directors to obtain the relief he desired. Respondent simply took matters into his own hands and, without advance notice, commenced litigation, allegedly on behalf of the Fund, in violation of the director demand requirement of Rule 23.1.

The Fund promptly moved to dismiss the action for failure by respondent to comply with the director demand requirement of Rule 23.1, and that motion was granted by the District Court. The District Court reasoned, based on a thorough review of the legislative history of the ICA, that ". . . under the statutory mandate the board of directors of an investment company is to be the first line of defense for the individual investor against any self dealing into which an adviser might be tempted." (5a). The District Court therefore held that ". . . a Rule 23.1 demand is a *sine qua non* in this type of litigation." (5a).

On appeal, the Court of Appeals reversed, holding that Rule 23.1 does not apply to actions brought under § 36(b) of the ICA. The Court of Appeals reasoned that § 36(b) actions are not derivative because an investment company does not itself possess the right to bring an action against its adviser for return of allegedly excessive fees.

This petition followed.

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3 The unaffiliated directors are: W. Giles Mellon, Professor of Business Administration in the Graduate School of Business Administration, Rutgers University; Alan J. Patricof, head of a private investment corporation and Dr. Yung Wong, managing Director of a venture capital investment firm. The affiliated directors are: Joseph H. Reich, President and Treasurer of the Fund, and Oscar L. Tang, Chairman of the Board and Secretary of the Fund.

Reasons for Granting the Writ

The decision of the Court of Appeals—holding that actions under § 36(b) of the ICA are exempt from the director demand requirement of Rule 23.1—is in direct and irreconcilable conflict with the recent decisions of two other federal courts of appeals on the same matter, i.e. the Courts of Appeals for the First and Third Circuits: *Grossman* v. *Johnson*, 674 F.2d 115 (1st Cir.), *cert. denied*, ___ U.S. ___, 103 S.Ct. 85 (1982); *Weiss* v. *Temporary Investment Fund*, ___ F.2d ___, CCH Fed. Sec. L. Rep. ¶ 98,865 (3d Cir., Nov. 12, 1982).

In addition, the Court of Appeals has decided an important question of federal law (i.e. the appropriate interrelationship of two federal statutes, the ICA and the Federal Rules of Civil Procedure) which has not been, but should be, settled by this Court.[4] The decision, while appearing to be merely procedural, effects a substantive change in the law with far-reaching consequences. Further, the decision is in conflict with the rationale of *Burks* v. *Lasker*, 441 U.S. 471 (1979), and, if permitted to stand, will undermine the fundamental principle of corporate self-governance in the mutual fund industry.

Finally, the decision of the Court of Appeals rests upon a faulty central premise, i.e. that an investment company itself has no right of action under § 36(b) and, therefore, a shareholder's action under § 36(b) is not truly derivative and does not trigger the director demand requirement of Rule 23.1. This premise is erroneous and does violence to

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4 As the Court of Appeals itself noted, resolution of the issue has "important ramifications for suits brought pursuant to § 36(b)." (15a).

the language of Rule 23.1, to the purpose of the ICA, and to this Court's recent rulings on implied rights of action.

In sum, a writ of certiorari should be granted because the decision of the Court of Appeals: (1) creates a conflict between the circuits; (2) involves an important question of federal law which has not been, but should be, settled by this Court, and (3) is erroneous.

I.

Two other federal courts of appeals have decided the precise issue presented herein, and both have reached the opposite conclusion from that of the Court of Appeals for the Second Circuit. After careful consideration, the Courts of Appeals for the First and Third Circuits rejected every argument relied on by the Court of Appeals for the Second Circuit and held that a demand on the directors is required in a shareholder's action brought under § 36(b) of the ICA. *Grossman* v. *Johnson*, 674 F.2d 115 (1st Cir.), *cert. denied*, ____ U.S. ____, 103 S.Ct. 85 (1982); *Weiss* v. *Temporary Investment Fund*, ____ F.2d ____, CCH Fed. Sec. L. Rep. ¶ 98,865 (3d Cir., Nov. 12, 1982). These opinions are also reproduced in the appendix to this petition.

The conflict between the circuits is direct and irreconcilable on this important matter.[5]

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5 All three decisions were rendered in 1982. The Second Circuit noted in this case that its decision conflicted with that of the First Circuit in *Grossman* (23a), and the Third Circuit noted in *Weiss* that its decision conflicted with that of the Second Circuit in this case (80a).

II.

The decision below, if allowed to stand, will undermine the fundamental principle of corporate self-governance embodied in the ICA.

The 1970 amendments to the ICA make clear that it was Congress' intent to preserve and strengthen, rather than eliminate, the role of the unaffiliated directors with respect to advisory fees. The Senate Report, which is the basic document in the legislative history of § 36(b), states:

> "These provisions highlight the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary."

S. Rep. No. 184, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. & Admin. News 4897, 4902-03.

Thus, as this Court recognized in *Burks* v. *Lasker*, 441 U.S. 471, 484-85 (1979):

> "In short, the structure and purpose of the ICA indicate that Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds' shareholders." (footnote omitted)

The District Court below similarly recognized that Congress' intent was to make the board of directors of an investment company "the first line of defense for the individual investor against any self-dealing into which an adviser might be tempted." (5a). Allowing a shareholder to bypass the board of directors and bring a § 36(b) action without even making a demand upon the directors is inconsistent with that purpose.

The director demand requirement is based on a policy favoring exhaustion of intracorporate remedies. As this Court held in *Hawes* v. *Oakland*, 104 U.S. 450, 460-61 (1882), before a shareholder may commence a derivative action,

> ". . . he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes."

This same purpose is the basis for the demand requirement of Rule 23.1:

> "The purpose of the demand requirement of Rule 23.1 is to allow a corporation to activate intracorporate remedies to address shareholder complaints prior to resorting to judicial intervention."

Mills v. *Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D.Ill. 1981). See also *Lerman* v. *ITB Management Corp.*, 58 F.R.D. 153, 157-58 (D.Mass. 1973); *Weiss* v. *Sunasco, Inc.*, 316 F.Supp. 1197, 1206 (E.D.Pa. 1970); Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171 (1976).

In view of the oversight role with respect to advisory fees which Congress gave to the unaffiliated directors of an investment company, the policy of exhaustion of intracorporate remedies has especially clear application to shareholder's derivative actions brought under § 36(b) of the ICA.

Faced with a timely demand, the directors can respond in a number of ways. If they find the claim has merit, they can (1) negotiate with the adviser to obtain a return of fees, (2) terminate the contract if the adviser refuses, and/or (3) institute a § 36(b) action.[6] If the directors find the claim lacks merit, they might nevertheless succeed in avoiding litigation by convincing the complaining shareholder that the fees are reasonable or that litigation would adversely affect all shareholders' interests.

In sum, the ICA imposes upon the directors the duty to evaluate advisory fees. To exempt § 36(b) actions from the director demand requirement of Rule 23.1 would allow a single shareholder to bypass the duly elected directors and force an investment company into expensive and time-consuming litigation. In this era of burgeoning caseloads, the director demand requirement is a particularly important protection against expensive and possibly unwarranted litigation.

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6 The Court of Appeals held that an investment company cannot itself bring a § 36(b) action. As shown below, that holding is erroneous. Moreover, even if an investment company has no right of action under § 36(b), a shareholder's action is still derivative and Rule 23.1 still applies. The other alternatives open to an investment company allow it an opportunity to resolve the shareholder's grievance without resort to litigation.

III.

The central error in the Court of Appeals' decision is its conclusion that an investment company does not itself have a right of action under § 36(b)[7] and that, accordingly, a shareholder's action under § 36(b) is not (in the words of Rule 23.1) one "to enforce a right which may properly be asserted by it." (18a). That holding ignores this Court's decisions as to the applicable framework for determining whether a statute creates an implied right of action and conflicts with the fundamental purpose of the ICA.

A.

In *Cort* v. *Ash*, 422 U.S. 66, 78 (1975), this Court held that the following factors should be considered on the issue of a statutory implied right of action:

> "First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,'—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is

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7 The Court of Appeals also relied for its holding on this Court's suggestion in *Burks* v. *Lasker, supra*, 441 U.S. at 484, that directors may not terminate suits under § 36(b). The Court of Appeals reasoned from this premise that the traditional reasons for a director demand do not apply. (36-37a). However, as just demonstrated, that conclusion does not follow, because a demand furthers the policy behind the exhaustion of intracorporate remedies even if the directors cannot terminate a § 36(b) action.

the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law."

Last term, this Court placed the following gloss upon the framework set forth in *Cort*:

> "In determining whether a private cause of action is implicit in a federal statutory scheme when the statute by its terms is silent on that issue, the initial focus must be on the state of the law at the time the legislation was enacted. More precisely, we must examine Congress' perception of the law that it was shaping or reshaping. When Congress enacts new legislation, the question is whether Congress intended to create a private remedy as a supplement to the express enforcement provisions of the statute. When Congress acts in a statutory context in which an implied private remedy has already been recognized by the courts, however, the inquiry logically is different. Congress need not have intended to create a new remedy, since one already existed; the question is whether Congress intended to preserve the preexisting remedy." (footnote omitted)

Merrill Lynch, Pierce, Fenner & Smith v. *Curran*, ___ U.S. ___, 102 S. Ct. 1825, 1839 (1982).

The Court of Appeals in this case did not specifically evaluate any of these factors. Although it recognized that the legislative history of § 36(b) was silent as to whether an investment company could bring an action to recover excessive advisory fees, it construed that silence as militating against an implied right of action (29a). Its rationale for that conclusion was that "[t]he relationship of

a fund to its adviser makes it part of the problem in a way that precludes it from being part of the solution, at least at the litigation stage." (34-35a). That conclusion is premised upon a fundamentally unsound view of the purpose of the ICA, as set forth in the legislative history and as interpreted by this Court in *Burks* v. *Lasker, supra.*

As this Court recognized in *Burks*, the thrust of the 1970 amendments to the ICA was to increase the participation of the unaffiliated directors in the operation of mutual funds. To deny the directors an opportunity to exercise that power would undercut the whole Congressional effort to enhance the role of unaffiliated directors. Although *Burks* dealt with a different ultimate issue, it aptly appraised the role Congress assigned to the unaffiliated directors in the 1970 amendments to the ICA:

> "Indeed, it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled." (footnote omitted)

Burks v. *Lasker, supra*, 441 U.S. at 485. Thus, an implied corporate right of action under § 36(b) is not at all inconsistent with the purpose of the ICA. To the contrary, it furthers the role of the directors as "watchdogs" and provides another means (in addition to suits by the SEC and shareholders) to recover excessive advisory fees.

Since an implied corporate right of action furthers the purpose of the ICA, the Court of Appeals for the Second Circuit erred in construing Congress' silence on this matter as indicating an intent to deprive an investment company of the right to bring an action against its adviser.

In addition, the Court of Appeals overlooked the state of the law at the time Congress enacted § 36(b). The common law predecessor to a § 36(b) action was a shareholder's suit against the adviser for "corporate waste," which was clearly derivative. 13 W. Fletcher, Cyclopedia of the Law of Private Corporations ¶¶ 5924, 5926-27 (rev. perm. ed. 1980). Moreover, a shareholder's implied right of action under former § 36 of the ICA (now § 36(a)), was uniformly held to be derivative. E.g. *Moses* v. *Burgin,* 445 F.2d 369 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971); *Brown* v. *Bullock,* 194 F. Supp. 207, 245 (S.D.N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961). In light of this background, Congress can and should be presumed to have known in 1970 that an investment company had its own right of action against its adviser.[8] Since there is no evidence that Congress intended to abolish this pre-existing right of an investment company to bring an action to recover excessive advisory fees, the Court of Appeals erred in holding that an investment company has no right of action under § 36(b).

B.

Even if (contrary to our analysis) an investment company does not itself have a right of action under § 36(b), a shareholder's action under § 36(b) is derivative and must be preceded by a director demand.

Rule 23.1 requires director demand "[i]n a derivative action brought by one or more shareholders or members to enforce a right of a corporation . . . , the corporation . . . having failed to enforce a right which may properly

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8 "Where Congress adopts a new law incorporating sections of a prior law, Congress can be presumed to have had knowledge of the interpretation given to the incorporated law." *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran, supra,* 102 S.Ct. at 1841 n. 66.

be asserted by it. . ." Neither the language nor the purpose of Rule 23.1 supports the Court of Appeals' holding that an action is "derivative" only if the right that a shareholder seeks to enforce is one that the corporation could assert *in a lawsuit*. That holding confuses the concepts of "right" and "remedy." Regardless of whether an investment company has a *remedy* under § 36(b)—it is beyond dispute that it has a *right* not to be charged excessive advisory fees.

Under § 36(b) a shareholder is permitted to bring an action against an investment advisor "on behalf of" an investment company. This provision clearly makes a shareholder's action derivative. As this Court noted in *Burks* v. *Lasker, supra,* 441 U.S. at 477, "[a] derivative suit is brought by shareholders to enforce a claim *on behalf of* the corporation." (emphasis supplied) This Court then went on to refer to § 36(b) suits as "derivative". *Id.* at 484.

Moreover, the policy underlying the director demand requirement of Rule 23.1—that of favoring exhaustion of intra-corporate remedies—is applicable to a shareholder's action under § 36(b) regardless of whether the investment company can itself bring such an action. As demonstrated above, the directors of an investment company have a number of methods to resolve a shareholder's grievance concerning advisory fees without resorting to litigation. The Court of Appeals set at naught these other remedies because of its belief that, as a practical matter, they would not be effective (19-20a n.7). That belief is unsupported and conflicts with the whole purpose of the ICA to make the unaffiliated directors the "independent watchdogs" of an investment company's interests. *Burks* v. *Lasker, supra,* 441 U.S. at 484.

In sum, the central premise of the Court of Appeals' decision is erroneous: an investment company has its own right of action under § 36(b), and even if it does not, a shareholder's action under § 36(b) is derivative and must comply with the director demand requirement of Rule 23.1.

Conclusion

For the foregoing reasons, a writ of certiorari should issue to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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January 14, 1983

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APPENDIX

Decision of the District Court

No. 81 Civ. 2602 (KTD).

United States District Court,
S. D. New York.

March 29, 1982.

MARTIN FOX,

Plaintiff,

—v.—

REICH & TANG, INC. and Daily Income Fund, Inc.,

Defendants.

Money market investment company shareholder brought derivative action against the company and the investment adviser to the company to recover allegedly excessive advisory fees paid by the company to the investment adviser. On the defendants' motion to dismiss, the District Court, Kevin Thomas Duffy, J., held that: (1) the shareholder was required to make demand on the company board of directors prior to bringing suit, and (2) the shareholder's failure to make such a demand was not excused by his unsubstantiated allegtion that all the company directors were involved in the wrongdoing and were necessarily hostile to his claim.

Motion granted.

Milberg, Weiss, Bershad & Specthrie, New York City, for plaintiff; Richard M. Meyer, New York City, of counsel.

Seward & Kissel, New York City, for defendant Reich & Tang, Inc.; Anthony R. Mansfield, New York City, of counsel.

Pollack & Kaminsky, New York City, for defendant Daily Income Fund, Inc.; Daniel A. Pollack, Edward T. McDermott, Frederick P. Schaffer, New York City, of counsel.

OPINION & ORDER

KEVIN THOMAS DUFFY, *District Judge*:

Martin Fox, a shareholder of Daily Income Fund, Inc. ("Fund"), sued the Fund, a money market investment company, and Reich & Tang, Inc. ("R&T"), the investment adviser to the Fund, to recover allegedly excessive advisory fees paid by the Fund to R&T. Plaintiff's derivative suit is premised on Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b), which places a fiduciary duty on an investment adviser with respect to compensation for services.[1] R&T is alleged to have breached that duty.

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1 15 U.S.C. § 80a-35(b) provides in relevant part:

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or

Defendants move to dismiss plaintiff's complaint for failing to plead that a demand was made on the Fund's board of directors prior to the filing of its complaint. Federal Rule of Civil Procedure 23.1 expressly states that a derivative suit complaint:

> shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . . and the reasons for his failure to obtain the action or for not making the effort.

Plaintiff concedes that no demand was made and suggests that Section 36(b) does not require such a demand.

The issues presented to this Court are two-fold: one, whether a demand is required in a Section 36(b) action and, two, if a demand is mandated, whether plaintiff is excused from the strictures of Fed.R.Civ.P. 23.1. The

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by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

* * * * * * *

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

answers to these questions have apparently resulted in a split within this district. Judge Ward recently held in *Markowitz v. Brody, et al.*, 90 F.R.D. 542 (S.D.N.Y.1981) that Section 36(b) does not obviate the need for a Rule 23.1 demand. In direct contrast, Judge Lasker states in dictum that "a demand on the directors of the Fund was not intended to be a prerequisite to suit under § 36(b)." *Blatt v. Dean Witter Reynolds Intercapital Inc., et al.*, 528 F.Supp. 1152, 1155 (S.D.N.Y.1981). Plaintiff argues that the *Blatt* decision should control this case for the following reasons: (1) the board of directors inability to terminate a Section 36(b) action renders any demand futile; (2) the legislative history supports plaintiff's contentions; and (3) a suit maintained under Section 16(b), an analogous section, need not comply with Rule 23.1. I do not find any of these arguments to be persuasive.

DISCUSSION

Before I begin to address plaintiff's three arguments, I must start my discussion of the question presented neither with the particular section of the Investment Company Act in issue nor with the Federal Rules of Civil Procedure, but with the overall congressional intent behind the Investment Company Act and its requirement that there be "unaffiliated" persons on the board of directors of investment companies. Clearly in mandating this type of membership on the decision making board of an investment company, Congress recognized the need for protection of investors from unscrupulous investment advisors who might be in a position to mulct the public investor. The advisor to an investment company is entrusted with enormous amounts of money collected from the public shareholders and also with the day-to-day management of

those funds. S.Rep.No.184, 91st Cong., 1st Sess. (1969) *reprinted in* [1970] U.S.Code Cong. & Admin.News, 4897, 4903, 4910. The temptation for self dealing whether through inflated fees or other nefarious schemes is self-evident.

It was to inhibit such self dealing that Congress insisted that directors unaffiliated with either the investment advisor or the Fund's principal underwriter constitute forty percent of the board of an investment company, 15 U.S.C. § 80a-10. "Since the adviser and underwriter are usually the same or related entities, a majority of the directors of most funds [including the Daily Income Fund] are unaffiliated with their managers." S.Rep.No.184, 91st Cong., 1st Sess. (1969) *reprinted in* [1970] U.S.Code Cong. & Admin.News at p. 4901. Thus, under the statutory mandate the board of directors of an investment company is to be the first line of defense for the individual investor against any self dealing onto which an advisor might be tempted. *Fogel v. Chesnutt*, 668 F.2d 100 at 104 (2d Cir. 1981); *Moses v. Burgin*, 445 F.2d 369, 376 (1st Cir.), *cert. denied*, 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed. 2d 547 (1971).

To require that an individual shareholder must first bring a problem to the board of an investment company therefore is not unreasonable. The unaffiliated directors can easily solve the problem (if it be real) without the need for litigation and its concomitant expense to the investment company. Thus, absent extraordinary circumstances, a Rule 23.1 demand is a *sine qua non* in this type of litigation. To hold otherwise is to rule that the congressional enactment of the Investment Company Act is, in the main, ineffective, and the arguments advanced by plaintiff do not lead to such an anomalous result.

1. *Termination of a Section 36(b) Suit*

Mr. Fox correctly states that a Section 36(b) suit cannot be terminated by the Fund's board of directors. ***Burks v. Lasker,*** 441 U.S. 471, 484, 99 S.Ct. 1831, 1840, 60 L.Ed.2d 404 (1979); *Markowitz, supra*, 90 F.R.D. at 559. However, it does not logically follow that this safeguard obliterates any need for compliance with Rule 23.1. Even assuming, as plaintiff suggests, that the Fund's board of directors, which consists of three disinterested and two interested members, are hostile to his claim, this is not adequate justification for abandonment of the Federal Rules of Civil Procedure. The underlying basis for imposing the demand requirement on a derivative suit plaintiff extends beyond providing an opportunity for director termination. Directors should be given an opportunity to redress an aggrieved plaintiff without resort to litigation, *Untermeyer v. Fidelity Daily Income Trust, et al.*, 79 F.R.D. 36, 42 (D.Mass.1978), or to institute a private right of action themselves.[2] Acceptance of plaintiff's argument would foreclose any opportunity for prelitigation director involvement and as such is untenable.

2. *Lesiglative History*

Mr. Fox's bare contention that a demand on the Fund director's in a Section 36(b) suit is futile and consequently unnecessary and unreasonable, is not sufficient reason to ignore Rule 23.1. A "statute should be so construed as to harmonize with the Federal Rules if that is at all feasible." 7 Moore's *Federal Practice* ¶ 86.04[4] at 4966.

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2 It is unsettled whether or not the directors are empowered to maintain a private right of action. *Fogel v. Chestnutt*, 668 F.2d 100, 112, (2d Cir. 1981); *Markowitz, supra*, 90 F.R.D. at 557 n.12; *Untermeyer, supra*, 79 F.R.D. at 46 n.30.

Section 36(b) silence on the necessity of demand on the directors assumes compliance with Rule 23.1. The Federal Rules may, however, be superseded by congressional enactments that "abridge, enlarge or modify any substantive right." 28 U.S.C. § 2072.

> [I]t is plain to the Court that a security holder's right to sue under Section 36(b) would in no way be modified or abridged within the meaning of 28 U.S.C. § 2072 simply by requiring compliance with Rule 23.1 . . . Section 2072 is not triggered by an instance where application of the federal rules would be unreasonable, but only in a case where the rules directly conflict with substantive rights. No such conflict exists here.

Markowitz, supra, 90 F.R.D. at 555.

The legislative history provides scant basis for concluding that statutory disharmony exists with the traditional demand requirement. Plaintiff cites passages from a Senate Committee Report expressing guarded concern for the directors' ability to "secure changes in the level of advisory fee rates in the mutual fund industry." H.R.Rep.No.2337, 89th Cong., 2d Sess. (1966) at 131. Congress's proper concern with the issue of investment adviser compensation does not raise the presumption that Congress intended to abrogate Rule 23.1 nor has plaintiff presented this Court with any language supporting such a presumption.

In 1970, Section 36(b) was added to the Investment Company Act to "specify that the adviser has a fiduciary duty with respect to compensation for services of other payments paid by the fund . . . to the adviser." S.Rep.No.184, 91st Cong., 1st Sess. (1969), *reprinted in*

[1970] U.S.Code Cong. & Admin.News at 4902. The enactment of Section 36(b),

> is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interests of its shareholders from the directors of such company to the judiciary.

Id. at 4903. This legislative history supports defendants' position that the congressional motivation behind Section 36(b) was to combine forces between the unaffiliated directors and the Federal courts to adequately and equitably supervise the amount of advisory fees. Plaintiff's inference that this supervision can only occur at the sacrifice of Rule 23.1 is unreasonable and unwarranted. It would indeed be inconsistent with the expressed motives of the 1970 Amendments "to have been willing to rely largely upon 'watchdogs' [unaffiliated directors] to protect shareholder interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled." *Burks, supra*, 441 U.S. at 485, 99 S.Ct. at 1840.

Judge Lasker's decision in *Blatt* ignored the congressional imperative for independent management of money market funds and mistakenly presumed, in reliance on *Boyko v. Reserve Fund, Inc.*, 68 F.R.D. 692 (S.D.N.Y.1975) (LPG), that the directors of an investment company are uniformly antagonistic to "an action

against the Fund's advisors for breach of fiduciary duty with respect to the receipt of compensation." *Id.* at 696. Section 10 of the Investment Company Act which mandates that directors unaffiliated with both the investment advisor and the fund's principal underwriter comprise forty percent of an investment company's board of directors, refutes on its face the presumption of hostility found in both the *Blatt* and *Boyko* decisions. Unless plaintiff is prepared to contest the true "disinterest" of each unaffiliated director, these independent board members will continue to examine with a discerning eye, as Congress intended, the payments of advisory fees. Without diligent observation of Rule 23.1 these directors will be denied an opportunity to fulfill the congressional mandate.

The importance of director involvement in the instant case is underscored in Section 36(b)(2), which provides that director approval of any advisory fees "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). This provision permits the court to scrutinize the directors judgment in approving adviser compensation and to evaluate whether the "deliberations of the directors were a matter of substance or a mere formality." S.Rep.No.184, 91st Cong., 1st Sess. (1969) *reprinted in* [1970] U.S.Code Cong. & Admin.News at 4910. Rule 23.1, which fosters director input, is crucial to the court's determination and despite plaintiff's arguments, it will not be ignored.

3. *Section 16(b)*

Plaintiff's final argument rests on an ill conceived analogy between Section 16(b)[3] of the Securities Exchange

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3 "Section 16(b) authorizes actions on behalf of a corporation to recover short-swing profits realized by corporate insiders as a

Act of 1934, 15 U.S.C. § 78p(b), and Section 36(b). Plaintiff cites cases for the proposition that Rule 23.1 does not apply to Section 16(b) cases, *Dottenheim v. Murchison*, 227 F.2d 737 (5th Cir. 1955), *cert. denied*, 351 U.S. 919, 76 S.Ct. 712, 100 L.Ed. 1451 (1957); *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016, 74 S.Ct. 872, 98 L.Ed. 1138 (1954). However, these cases dealt with the contemporaneous ownership requirement of Rule 23.1 and not the demand clause at issue here. Thus, plaintiff's reliance on this case law is misplaced. This crucial distinction destroys plaintiff's suggested analogy between Section 16(b) and Section 36(b).

I am convinced that Rule 23.1 and Section 36(b) can and should co-exist compatibly. Plaintiff's arguments do not persuade me otherwise. Plaintiff's failure to make a Rule 23.1 demand on the fund directors is grounds for dismissal of the complaint unless Mr. Fox's failure to make such a demand may be excused by some extraordinary circumstances.

Plaintiff's complaint states at paragraph 14:

> No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this action for the reason that no such demand is required under § 36(b) of the Act. Moreover, all of the directors are beholden to R&T for their positions and have participated in the wrongs complained of in this action. Their initiation of an action like the instant one would place the prosecution of this action in the hands of persons hostile to its success.

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result of their purchases and sales of the corporation's equity securities." *Markowitz, supra*, 90 F.R.D. at 551.

This averment, besides being inconsistent with plaintiff's argument that the directors cannot maintain their own action, presents no adequate grounds for disobedience with Rule 23.1. The contention that all the Fund directors are involved in the wrongdoing and necessarily hostile to plaintiff's claim is unfounded. First of all, this presumption is contrary to the congressional entrustment of surveillance responsibilities to the unaffiliated directors discussed *supra*. *Burks, supra*, 441 U.S. at 486, 99 S.Ct. at 1841. Secondly, plaintiff's only proof of the potential hostility of the Fund directors to the instant case is found in the Fund's proxy statement dated September 4, 1981. This statement, issued four months after plaintiff filed his complaint discusses the instant litigation: "The Manager and the Corporation believe that the advisory fees paid by the Corporation have not been and are not excessive, and the Manager and the Corporation intend to deny and contest the material allegations of the complaint." at p. 10. This post-complaint hindsight cannot excuse Mr. Fox's failure to make a demand on the directors before filing his complaint.

Plaintiff has presented no justification for his noncompliance with Rule 23.1. Plaintiff alternatively requests that if this Court rules unfavorably, leave be granted to file an amended complaint. The rule in this Circuit is that leave to file amended complaints is usually freely granted absent prejudice to the parties. *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 856 (2d Cir. 1981). In the instant case, prejudice to the directors would result from plaintiff's dilatory amendment. One of the purposes of Rule 23.1 is to allow the directors to respond to plaintiff's claim prior to the initiation of a lawsuit. Allowing plaintiff to now file an amended complaint

would make a mockery of the demand requirement. *See Shlensky v. Dorsey*, 574 F.2d 131, 141 (3d Cir. 1978); *Weiss v. Temporary Investment Fund, Inc.*, 520 F.Supp. 1098 (D.C.Del.1981).

Thus, defendants' motion to dismiss is granted and plaintiff is denied leave to file an amended complaint.

SO ORDERED.

Decision of the Court of Appeals

No. 74, Docket 82-7296.

United States Court of Appeals,
Second Circuit.

Argued September 16, 1982.
Decided October 26, 1982.

MARTIN FOX,

Plaintiff-Appellant,

—v.—

REICH & TANG, INC. and
DAILY INCOME FUND, INC.,

Defendants-Appellees.

Shareholder appealed from dismissal by the United States District Court for the Southern District of New York, Kevin Thomas Duffy, J., 94 F.R.D. 94, of shareholder's action to recover allegedly excessive fees paid by investment company to its adviser. The Court of Appeals, Irving R. Kaufman, Circuit Judge, held that: (1) investment company did not possess right of action under section of Investment Company Act of 1940 that provides right of action to recover excessive fees by Securities and Exchange Commission or by security holder, and (2) demand requirement of Federal Rule of Civil Procedure

governing derivative actions was inapplicable to shareholder's suit.

Reversed and remanded.

Richard M. Meyer, New York City (Milberg, Weiss, Bershad & Specthrie, New York City, of counsel), for plaintiff-appellant.

Daniel A. Pollack, New York City (Pollack & Kaminsky, Frederick P. Schaffer, New York City, of counsel), for defendant-appellee Daily Income Fund, Inc.

Seward & Kissel, New York City (Anthony R. Mansfield, New York City, of counsel), for defendant-appellee Reich & Tang, Inc.

Before FEINBERG, *Chief Judge*, and FRIENDLY and KAUFMAN, *Circuit Judges*.

IRVING R. KAUFMAN, *Circuit Judge:*

This case presents an issue of first impression in this Circuit. The question before us is whether, in a shareholder action brought pursuant to § 36(b) of the Investment Company Act of 1940 to recover allegedly excessive fees paid by an investment company to its adviser,[1] the

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1 Section 36(b) imposes upon the investment adviser of a registered investment company "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). It creates a cause of action for breach of that duty, *id.*, and specifically limits "[a]ny award of damages . . . to the actual damages resulting from the breach of fiduciary duty[,] . . . in no event exceed[ing] the

shareholder plaintiff is required to plead that a "demand" was made on the company's board of directors prior to filing of the complaint.[2] At first blush, resolution of this question would seem to require merely clarification of a technical pleading rule. As our discussion makes clear, however, analysis of the issue is not uncomplicated, nor is our conclusion without important ramifications for suits brought pursuant to § 36(b).

I

Because this case comes to us from a dismissal at the pleading stage, the factual record is sparse. Martin Fox, a shareholder of Daily Income Fund, Inc. ("the Fund"), brought this action on behalf of the Fund to recover allegedly excessive fees paid by the Fund to its investment adviser, Reich & Tang, Inc. ("R & T"). The Fund, an open-end investment company of the type commonly referred to as a "money-market fund," pursues as its basic business strategy the goal of achieving high current income levels while preserving capital. To this end, it invests in a portfolio of short-term money market instruments, principally United States government and federal agency obligations, obligations of major banks, and prime commercial paper. The Fund experienced a dramatic surge in its assets, in a relatively short period of

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amount of compensation or payments received from [the] investment company. . . ." The legislative history reveals that Congress created this somewhat particularized fiduciary duty with specific reference to the recurring problem of payment of excessive adviser and management fees, *e.g.*, S.Rep. No. 184, 91st Cong., 1st Sess. 5-6 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News 4897, 4901-02.

2 This pleading requirement in the federal courts is embodied in Federal Rule of Civil Procedure 23.1, the text of which is set out at note 6.

time. As of June 30, 1978, the Fund's net assets were approximately $75 million. Less than three years later, on April 15, 1981, they had reached a level of $775,000,000. Precisely this sort of "dramatic growth"[3] impelled enactment of the 1970 amendments to the Investment Company Act of 1940, and, in particular, § 36(b), which created a cause of action for return of excessive adviser fees. Because fees are usually calculated as a percentage of assets, substantial portfolio appreciation brings with it the risk of unduly high adviser compensation. *See* S.Rep. No. 184, 91st Cong., 1st Sess. 6 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4902; *see also* J. Barnard, Jr., *Reciprocal Business, Sales Charges and Management Fees,* in 1966 Fed. B.A. Conference on Mutual Funds 127-29.

Despite this substantial increase in Fund assets, no adjustment was made in the rate at which R & T was to be paid for investment advice and other management services rendered. R & T's fee was originally set one-half of one percent of the Fund's net assets, and it remains fixed at that rate. Consequently, yearly payments by the Fund to its adviser increased from approximately $375,000 in

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3 S.Rep. No. 184, 91st Cong., 1st Sess. 3 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4899. After passage of the Investment Company Act of 1940, the industry experienced a period of relative stability. During the first year 436 companies registered, pursuant to the Act. At the end of fiscal year 1959, the number of companies had increased to only 453 with aggregate assets of about $20,000,000,000. By 1966, just seven years later, 727 companies were registered, representing assets of nearly $50 billion. 1966 SEC Ann.Rep. 100. Not surprisingly, that same year Congress requested the Securities and Exchange Commission to investigate this matter. The SEC's findings, and recommendations for legislative action are contained in *Report on the Public Policy Implications of Investment Company Growth, reprinted in* H.R.Rep. No. 2337, 89th Cong., 2d Sess. (1966) *("1966 SEC Report").*

1978, to a projected $3,875,000 in 1981. During the fiscal year ending June 30, 1980, R & T received more than $2,000,000 in management fees from the Fund. It is this extraordinary leap in fees of which Fox complains.

Fox's complaint alleged that management of the assets of a money market fund requires no detailed analysis of industries (or of large individual industrial concerns), nor the retention of a large staff of highly paid, sophisticated securities analysts. Essentially, he claimed that investment decisions are more or less routine, concentrated as they are in the relatively limited realm of "turning over" money market investments with a small number of institutions. In short, Fox alleged that R & T was continuing to provide the services it had always rendered, for what had become an exorbitant amount of money.

Rather than approach the Fund's directors with his grievance, Fox chose to allege in his complaint that no "demand" is required under § 36(b).[4] In response, the

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4 Fox's complaint asserted, in addition to this legal conclusion, that "all of the [Fund's] directors are beholden to R & T for their positions and have participated in the wrongs complained of in this action. Their initiation of an action like the instant one would place the prosecution of this action in the hands of persons hostile to its success." Apparently by way of response, the Fund notes that a majority of its Board of Directors, three of five, are "disinterested directors." We need not deal with the effect of these statements. Some courts have held demand will be excused when a plaintiff shows that a majority of the investment company's directors possess an interest in the subject matter of the lawsuit sufficient to conclude that it would have been futile to ask for board action. *E.g.*, *Markowitz v. Brody*, 90 F.R.D. 542, 556 (S.D.N.Y. 1981). Yet, the mere presence of a majority of directors not directly employed by the adviser may not automatically result in the conclusion that a demand will be required. *See Lewis v. Curtis*, 671 F.2d 779, 785-86 (3d Cir. 1982). Because we agree with Fox that a § 36(b) action is exempt from the director demand requirement of Rule 23.1, we do not pass on the excuse issue.

Fund (later joined by R & T) moved to dismiss for failure to comply with Rule 23.1. After noting that the issue had resulted in a split among the district courts in this Circuit,[5] Judge Duffy concluded that a Rule 23.1 demand was required in a § 36(b) suit, and dismissed the complaint. Fox appealed. For the reasons stated below, we disagree with the district court's conclusion, 94 F.R.D. 94, and reverse.

II

We begin by noting that the Rule 23.1 demand requirement applies only when a corporation or association has "failed to enforce a right which may properly be asserted by it."[6] We agree with Fox that the rule applies only when

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5 Indeed, the conflict between previous district court cases could not be more stark. In *Markowitz v. Brody, supra,* 90 F.R.D. at 554-55, Judge Ward concluded that Rule 23.1 applies to § 36(b) shareholder suits. *Accord, Gartenberg v. Merrill Lynch Asset Management, Inc.,* 91 F.R.D. 524, 526-28 (S.D.N.Y.1981). In direct contrast, Judge Lasker has stated: "a demand on the directors of the fund was not intended to be a prerequisite to suit under § 36(b)." *Blatt v. Dean Witter Reynolds Intercapital, Inc.,* 528 F.Supp. 1152, 1155 (S.D.N.Y.1982) (dictum). *Cf. Boyko v. Reserve Fund, Inc.,* 68 F.R.D. 692, 696 (S.D.N.Y.1975) (Gagliardi, J.) (when at least one affiliated or interested director on mutual fund board, futility of demand will be presumed, and, therefore, Rule 23.1 will be satisfied).

6 Fed.R.Civ.P. 23.1 provides, in its entirety:

> Derivative Actions by Shareholders
>
> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer

the specified entity has an opportunity to "assert," in a court, the same action under the same rule of law on which the shareholder plaintiff relies. Thus, if the Fund may not sue pursuant to § 36(b), no demand upon its board of directors will be required. In rejecting the Fund's argument that even if it cannot bring an action under § 36(b), a demand must be made upon its directors to utilize other, informal means to "enforce its right" to return of excessive adviser fees, Brief of Defendant-Appellee Daily Income Fund, Inc. at 5-6,[7] we announce no

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jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

7 As indicated, we disagree that availability of informal methods of attempting to recoup excessive adviser fees is sufficient to trigger the demand requirement of Rule 23.1. Moreover, we find the examples given by the Fund—negotiating with the Adviser to obtain a refund, and terminating the contract, Brief for Defendant-Appellee Daily Income Fund, Inc. at 5-6—not persuasive. Negotiations may well fail, and termination of the contract, although perhaps depriving the adviser of future business, may not effect the remedy sought by the shareholder plaintiff, which is the return of excessive fees. Additionally, "a mutual fund cannot, as a practical matter sever its relationship with [its] adviser." S.Rep. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4901. Moreover, given the directors' past relationship with the adviser in approving the contract in the first place, 15 U.S.C. § 80a-15(c), the

new rule of law. As long ago as the beginning of this century, the Supreme Court construed Equity Rule 94, 104 U.S. ix (1882), the precursor of Rule 23.1, and determined that its nearly identical language[8] referred to "a suit founded on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff." *Delaware & Hudson Co. v. Albany & Susq. R.R.*, 213 U.S. 435, 447, 29 S.Ct. 540, 543, 53 L.Ed. 862 (1909); *see also Ross v. Bernhard,* 396 U.S. 531, 534-35, 90 S.Ct. 733, 735-736, 24 L.Ed.2d 729 (1970).

Accordingly, we turn initially to the question whether an investment company can bring an action under § 36(b) of the Investment Company Act of 1940.

A

Our starting point, as in every case involving construction of a statute, is examination of the language utilized

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likelihood that negotiations will prove effective is highly speculative. *See Blatt v. Dean Witter Reynolds Intercapital, Inc., supra,* 528 F.Supp. at 1156 (dictum). In reaching this conclusion, we do not ignore the salutary purpose served by requiring complaining shareholders to first "activate intracorporate remedies," *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D.Ill.1981). Rather we conclude that a demand will not be mandated unless, should intracorporate efforts prove insufficient, the corporation itself may bring suit. *Id.* (quoting *Hawes v. Oakland,* 104 U.S. 450, 460-61, 26 L.Ed. 827 (1882)).

8 Equity Rule 94 provided, in relevant part:

> Every bill brought by one or more stockholders in a corporation against the corporation and other parties *founded upon the rights which may properly be asserted by the corporation* . . . must . . . set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors . . . .

Eq.R. 94, 104 U.S. ix (1882) (emphasis added).

by Congress. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 197, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668 (1976). The second sentence of § 36(b) is quite clear that an action may be brought under that subsection only "by the [Securities and Exchange] Commission, or by a security holder of [a] registered investment company on behalf of such company."[9] No action by the investment company is

9 The full text of § 36(b) is as follows:

15 U.S.C. § 80a-35. Breach of fiduciary duty

* * * * * *

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or

authorized. When Congress has provided specific and elaborate enforcement provisions, and entrusted their use to particular parties, we will not lightly assume an unexpressed intention to create additional ones. *See Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n*, 453 U.S. 1, 13-15, 101 S.Ct. 2615, 2622-2624, 69 L.Ed.2d 435 (1981).

Appellee points to the words "on behalf of such company," and argues they demonstrate that the right of the shareholder created by § 36(b) is derivative, and therefore the director demand requirement of Rule 23.1 applies, as it does to other "derivative" actions in the federal courts.

The words "on behalf of" do not create by implication a statutory right of the company itself to sue, from which the stockholders' right may be said to be "derivative."

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payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

These words, which apply as much to the Securities and Exchange Commission as to a private security holder, signify only that either party so entitled to bring an action under § 36(b) must do so to seek return of excessive management fees to the company treasury and not to individual or governmental coffers. The action is not, strictly speaking, "derivative" in the sense of deriving from a right properly asserted by the corporation, but rather constitutes individual security holders as "private attorneys general" to assist in the enforcement of a duty imposed by the statute on investment advisers.

We recognize that the one Court of Appeals to have considered the question reached a different conclusion. *Grossman v. Johnson,* 674 F.2d 115 (1st Cir.), *cert. denied,* ___ U.S. _____, 103 S.Ct. 85, 73 L.Ed.2d— (1982). In rejecting the argument that because § 36(b) explicitly provides for, it therefore only permits, suit by the SEC or a security holder, the First Circuit stated:

> We cannot believe, however, that, for example, a new and independent board of directors, intent on recovering excessive fees from an investment adviser, would be precluded from suing under section 36(b).

Id. at 120. Equally cogent is our belief that this situation was regarded as so remote or unlikely that the legislature chose not to provide for it, and was wary of permitting the Fund to control the suit, *see Burks v. Lasker,* 441 U.S. 471, 483-84, 99 S.Ct. 1831, 1839-1840, 60 L.Ed.2d 404 (1979). Moreover, the *Grossman* court offers scant support for its conclusion that the Fund may sue. It refers, first, to the "on behalf of" language in the statute. We have already indicated the meaning we attach to that phrase. Similarly, we are unpersuaded by the argument that "Congress could well have believed that,

though it was appropriate to specify that the Commission and shareholders had the new statutory cause of action[,] . . . it was unnecessary to say with particularity that the company also did." *Id.* This seems totally inconsistent with what we would expect Congress to have done. If Congress had intended to provide the company with a cause of action, it would have passed a statute saying so, in which case the derivative right of a shareholder to initiate suit would have followed automatically. A mere statement of what Congress "could have believed" seems to us not enough. Congress has not expressed, anywhere at all, the policy appellee would have us adopt.

Moreover, as the First Circuit itself notes, § 36(b)(3) "directly forbids" an action against any person "other than the recipient of . . . compensation or payments [for adviser services]." Yet, the opinion relies on the proceeding in that case having been brought against "forbidden" defendants (the "disinterested" directors and the Fund itself) as support for its conclusion that a § 36(b) suit is a typical derivative suit. The idea, apparently, is that Grossman was operating under the assumption that a § 36(b) action is the standard derivative action, in which the complaining shareholder would join the company and its directors, "in the ordinary fashion," after the corporation had declined to initiate the suit as a plaintiff. *See* H. Henn, *Handbook of the Law of Corporations and Other Business Enterprises* § 358 at 750 (2d ed. 1970). It is difficult to understand how a defect in a pleading—or a misreading of § 36(b)—can take precedence over the clear dictates of a statute.

The language of a statute controls when sufficiently clear in its context. *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 201, 96 S.Ct. at 1384. Nevertheless, mindful

of our obligation to supplement application of rules of statutory construction by searching for "persuasive evidence of a contrary legislative intent," *Transamerica Mortgage Advisors, Inc. v. Lewis, supra,* 444 U.S. 11 at 21, 100 S.Ct. 242 at 247, 62 L.Ed.2d 146 we move now to an examination of the legislative history of § 36(b).

B

Prior to enactment of the Investment Company Act of 1940, open-end investment companies,[10] or mutual funds, played a minor role in the world of finance. In 1940, investment companies held assets of approximately $2.1 billion; of this sum, mutual funds accounted for $450 million. *1966 SEC Report 2.* The 1940 Act was directed at the most flagrant self-dealing and other abuses within the investment company industry. *See United States v. Deutsch,* 451 F.2d 98, 108 (2d Cir. 1971), *cert. denied,* 404 U.S. 1019, 92 S.Ct. 682, 30 L.Ed.2d 667 (1972). It prohibits, for example, most transactions between investment companies and their advisers. 15 U.S.C. § 80a-17. Generally, the Act requires at least forty percent of a fund's board of directors to be "unaffiliated" with the adviser, and it mandates that payment for management and other investment advice be the subject of a contract between the fund and the adviser which has received both shareholder and director approval, 15 U.S.C. § 80a-15(a), (c). Moreover, a duty is imposed on the directors of a fund to evaluate the terms of the adviser contract. 15 U.S.C. 80a-15(c).

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10 An "open-end" company is one which continually offers shares for sale and will redeem outstanding shares at their proportionate net asset value. 15 U.S.C. § 80a-5(a)(1).

The 1940 Act proved most successful in controlling the serious problems covered by its broad brush approach. Indeed, an ironic measure of its success has been the public's growing confidence in the investment company industry, which led to a period of extraordinary growth in the number of investors and in net asset levels of the funds. In turn, this expansion created a specific and largely unforeseen problem. Because adviser fees are usually calculated at a percentage of a fund's net assets, and vary in proportion as portfolio value goes up or down, a period of sustained industry success would—and did—yield substantially increased fees. But the Act "did not provide any mechanism by which the fairness of management contracts could be tested in court." S.Rep. No. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad.News at 4901.

What the drafters of the 1940 Act *did* foresee, in a general way, was the possibility that the future success of the industry might entail the need for statutory change. As a result, a section of the original statute provided (and still states) that the SEC may study the ramifications of "any substantial further increase in size of investment companies . . . involving the protection of investors or the public interest," and present recommendations for legislative change. 15 U.S.C. § 80a-14(b). Accordingly, in 1958, the Commission authorized the securities research unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to study investment companies and report its findings. The Wharton Report identified the salient issues, but made no proposals. Subsequently, the Commission undertook further research, and presented the results and recommendations for detailed amending legislation in its *Report on the*

Public Policy Implications of Investment Company Growth, transmitted to Congress in 1966.

The *1966 SEC Report* reiterated the Wharton unit's findings. It concluded that mangement fees tended to be fixed at the traditional level of one-half of one percent of the fund's net assets. It noted that they markedly exceeded fees charged by investment advisers to other institutional clients and the cost of management to those funds which manage themselves. Moreover, no evidence existed to demonstrate a willingness on the part of the advisers to provide services at a "reasonable" rate, not necessarily a percentage of assets. The Report further stated that the 1940 Act was not equipped to deal with this emerging problem, and that shareholder suits, although occasionally forcing settlements, basically had been ineffective. *1966 SEC Report* 84-149. To deal with this issue, the SEC recommended amending the Act to require that mangement fees be "reasonable." Reasonableness was to be determined by reference to various criteria, including the fees paid for similar services by like institutions, the nature and quality of services rendered, and any other factors determined to be appropriate in the public interest. The SEC was to have an enforcement action available to it (as in fact it does under present § 36(b)), and would also possess the right to intervene in private shareholder suits. *Id.* at 143-47. Nowhere does the Report mention an action brought by the investment company itself.

The standard of "reasonableness" proposed in the *1966 SEC Report* was contained in the first bills considered by Congress, H.R.9510, 90th Cong., 1st Sess. § 8(d) (1967) and S.1659, 90th Cong., 1st Sess. § 8(d) (1967). Not surprisingly, it was met by vigorous industry opposi-

tion, *see generally Hearings on S.1659 Before the Senate Comm. on Baking and Currency*, 90th Cong., 1st Sess., pt. 1, at 191-201 ("*1967 Senate Hearings*"); *Investment Company Act Amendments of 1967: Hearings on H.R.9510, H.R.9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 90th Cong., 1st Sess., ser. 90-21, pt. 1, at 237-43 (1967) (statement of John R. Haire, chairman-elect, Investment Company Institute), and neither bill passed. The industry claimed fees were already reasonable, the legislation would encourage "strike" suits, and the SEC would be empowered to regulate a competitive industry. *1967 Senate Hearings* at 191-92, 202. In one sense, of course, the relative merits of each side of this debate are irrelevant. The ultimate passage of § 36(b) settled the issue and expressed the legislative conclusion that imposing a "fiduciary duty" and leaving its exegesis to the judiciary[11] provided the best solution. This decision represented the compromise reached by industry repre-

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11 *E.g.*, 15 U.S.C. § 80a-35(b)(2); *see 1967 Senate Hearings* at 1016:

> It is for Congress to decide in each case just what mix of administrative and judicial participation is best adapted to the problem in hand. One end of the spectrum provides more in administrative expertise and uniformity, the other more in those qualities of restraint, freedom from bureaucratic rigidity, open-mindedness and good sense that judges like to believe are special attributes of courts.
>
> (Statement of Judge Henry J. Friendly)

The quoted language goes to the question whether case-by-case judicial evaluation of allegations of excessive adviser fees, on the one hand, or an administrative procedure which would also weigh industry-wide factors, on the other, is best suited to adjudication of shareholder complaints. Congress apparently believed, along with my brother Friendly, that courts possessed sufficient good qualities to make them appropriate forums in which § 36(b) complaints might be heard.

sentatives and the SEC. *See Hearings on H.R.11995, S.2224, H.R.13754, H.R.14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce,* 91st Cong., 1st Sess., ser. 91-33, pt. 1, at 138 (1969) ("*1969 House Hearings*"). On the other hand, that the focus of legislative inquiry, from the introduction of the first bills through a period of several years until enactment, remained fixed on this question, is of special significance for our purpose. The normal conclusion to be drawn from intensive—and exclusive—Congressional scrutiny of a particular subject is that Congress did not concern itself with others. Put differently, if the voluminous legislative history of § 36(b) and its unsuccessful predecessors persuades us that Congress's first order of business was now to make shareholder suits (and SEC enforcement actions) effective, rather than whether it might also be useful to sanction suit by a fund, we would be hard-pressed to conclude that Congress intended to empower the courts to permit a fund to sue.

It is obviously difficult, under the best of circumstances, to prove a negative. Because the extensive legislative history of § 36(b) neither approves nor disapproves suits brought directly by mutual funds, it cannot be shown to a certainty (and perhaps never to the satisfaction of those disposed to believe otherwise) that Congress foreclosed their use of the section. What *can* be shown, in this instance, is that the Congressional approach to a specific problem—excessive adviser fees—consisted of, first, identifying the source of that problem; next, determining why the 1940 Act, in other respects effective, had been and would continue to be incapable of remedying it; and finally, amending the relevant portion of the Act. If, therefore, the source of the problem is inconsistent with a

corporate right of action as a solution, we can say with confidence that Congress never intended to create one. Moreover, if the flaw in the 1940 Act was unrelated to the unavailability of a suit by the fund, our conclusion becomes virtually certain, since we know that the statutory lacuna was filled by a provision conspicuous for its failure to name the fund as a potential plaintiff.

Several years of careful study indicated that the problem derived from the peculiar nature of the mutual fund industry (seen in light of its rapid growth):

> Mutual funds, with rare exceptions, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, that are separately owned and operated. These separate organizations are usually called investment advisers. The advisers select the funds' investments and operate their businesses. For these services they receive management or advisory fees. These fees are usually calculated at a percentage of the funds' net assets and fluctuate with the value of the funds' portfolio.
>
> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the

mutual fund industry in the same manner as they do in other sectors of the American economy.

* * * * *

It is noted . . . that problems arise due to the economies of scale attributable to the dramatic growth of the mutual fund industry. In some instances these economies of scale have not been shared with investors. Recently there has been a desirable tendency on the part of some fund managers to reduce their effective charges as the fund grows in size. Accordingly, the best industry practice will provide a guide.

S.Rep. No. 184, 91st Cong., 1st Sess. 5-6 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad.News at 4901-02; *see also 1966 SEC Report* 131; H.R.Rep. No. 1382, 91st Cong., 2d Sess. 7 (1970); *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976).

Additionally, the requirement that a percentage of the directors of the investment company be "independent" of the adviser and underwriter, 15 U.S.C. § 80a-10, and that they annually approve the adviser contract, 15 U.S.C. § 80a-15, cannot seriously be expected to induce arm's-length bargaining. As the SEC long ago recognized, any so-called independent directors would "obviously have to be satisfactory to the dominating stockholders who are in a position to continue to elect a responsive board." *Petroleum & Trading Corp.*, 11 S.E.C. 389, 393 (1942); *see 1969 House Hearings*, ser. 90-22 at 696-97 (testimony of SEC Chairman Manuel F. Cohen).

In sum, the root of the excessive adviser fee problem is basically incompatible with a corporate right of action as an effective solution. We believe the Senate Committee on Banking and Currency (referring to the bill eventually passed) had in mind exactly the plaintiffs it named and no others when it stated: "[Y]our committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of [adviser] fees, there should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty." S.Rep. No. 184, 91st Cong., 1st Sess. 1 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad.News at 4898. Neither the parties' briefs nor our own research has disclosed any indication in the comprehensive legislative history of § 36(b) that suits by directors themselves were to be expected or encouraged. Although we agree with Judge Duffy that Congress intended the directors would perform a "watchdog" function, *see also Burks v. Lasker, supra,* 441 U.S. at 484, 99 S.Ct. at 1840; *Boyko v. Reserve Fund, Inc., supra,* 68 F.R.D. at 695-96 n.2, it defies logic to conclude their contemplated role included suing their advisers.

Moreover, the 1940 Act was not deficient or ineffective because a fund could not use it. By the time consideration of the 1970 Amendments was at hand, it had become clear that shareholders were hard pressed to prove a "gross abuse of trust," the standard of old § 36. *Saxe v. Brady,* 40 Del.Ch. 474, 184 A.2d 602 (1962) (Seitz, Ch.), decided under traditional corporate law concepts, provided the model adhered to by federal courts in suits alleging excessive management fees. *See Kurach v. Weissman,* 49 F.R.D. 304, 305-06 (S.D.N.Y. 1970). In *Saxe,* mutual fund shareholders challenged adviser fees amounting to one-half of one percent of net assets. The

adviser contract had been approved almost unanimously by the shareholders. Chancellor Seitz (now Chief Judge of the Third Circuit Court of Appeals) concluded that the adviser fee level must be evaluated according to the usual legal rules applicable to shareholder ratification cases:

> When the stockholders ratify a transaction, the interested parties are relieved of the burden of proving the fairness of the transaction. The burden then falls on the objecting stockholders to convince the court that no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given.

Saxe v. Brady, supra, 40 Del.Ch. at 486, 184 A.2d at 610. In concluding that plaintiffs must show "actual waste," or a fee level so high as to be "unconscionable," *id.*, the Chancellor noted that a 0.5% adviser fee rate was common and that the shareholders had approved the adviser contract virtually unanimously. *Id.* at 489, 184 A.2d at 611-12. Since these determinative factors were inevitably present, showing "actual waste" and overcoming a presumption of "sound business judgment" was well nigh impossible. *Kurach v. Weissman, supra*, 49 F.R.D. at 305-06; *Goodman v. Von Der Heyde*, [1969-1970 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 92,541 (S.D.N.Y.1969); *Lessac v. Television-Elecs. Fund*, [1967-1969 Transfer Binder] Fed.Sec.L.Rep. ¶ 92,305 (S.D.N.Y.1968); *see Rosenfeld v. Black*, 445 F.2d 1337, 1345-46 (2d Cir.1971). Recognizing that shareholder plaintiffs had difficulty sustaining their burdens, Congress changed only the standard of duty. *Cf. Burks v. Lasker, supra*, 441 U.S. at 483-84, 99 S.Ct. at 1839-1840 (1979).

Despite the long odds, shareholders did sue for return of allegedly excessive fees. Starting in 1959, over fifty suits were instituted under common law principles and pursuant to the 1940 Act. *1966 SEC Report* 132. What happened is instructive. Advisers were sometimes willing to settle, because even *Saxe* left open the possibility that the point might be reached at which "profits . . . outstripp[ed] any reasonable relationship to expenses and effort even in a legal sense." 40 Del.Ch. at 498, 184 A.2d at 616-17. Given the substantial sums at stake, this willingness is not surprising. For precisely the opposite reason—that is, the slim likelihood of success on the merits—courts felt constrained to approve settlements, even when the terms were something less than desirable. *E.g., Jurach v. Weissman, supra*, 49 F.R.D. at 305. This confluence of inconsistent, but complementary, motives resulted in reduction of adviser fees in individual cases, but the effect on the industry as a whole was insignificant. In 1967, SEC Chairman Manuel Cohen noted that "[t]he median advisory fee paid by the 59 externally managed mutual funds with net assets of $100 million or more in fiscal years ending in 1966 was still 0.48 percent, down only 0.02 percent from the traditional 0.50 percent rate." *1967 Senate Hearings*, pt. 1, at 14-15. Obviously, the pressure to settle was analytically unrelated to the identity of the plaintiff.

Our retracing of the analysis employed by Congress, and of its extensive documentation, persuades us that an investment company was not intended to possess a right of action under § 36(b). The relationship of a Fund to its adviser makes it a part of the problem in a way that precludes it from being part of the solution, at least at the

litigation stage. The provision for evaluation of the adviser contract, 15 U.S.C. § 80a-15(c), and the general tightening of the powers of disinterested directors, *e.g.*, 15 U.S.C. §§ 80a-2(a)(19); 80a-10(a); 80a-15(c), provide for "an independent check on management . . . and the representation of shareholder interests in investment company affairs," S.Rep. No. 184, 91st Cong., 1st Sess. 32 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4927. We take this language to be nothing more nor less than a declaration by Congress that it was imposing duties on the directors to run the ongoing business of the Fund in a responsible manner, and with due regard for investors. *Cf. United States v. National Ass'n of Sec. Dealers*, 422 U.S. 694, 705 n. 13, 95 S.Ct., 2427, 2436 n. 13, 45 L.Ed.2d 486 (1975)(1940 Act concerned with imposing controls on "internal management [and] practices of investment companies"). These functions and duties having proved ineffective in a particular case, at least in the eyes of the complaining shareholder plaintiff, the issue for Congressional scrutiny was how to particularize the already existing statute to make judicial relief a genuine possibility. Experience with shareholder suits had demonstrated that the *Saxe* standard, drawn from pre-existing corporate law principles but applied to the investment company industry, was useless. The fiduciary duty standard was imposed, and courts were empowered to view "all the circumstances," 15 U.S.C. § 80a-35(b)(2). The extensive number of suits brought under the earlier, less favorable law suggested that shareholders would move with alacrity pursuant to the new one. Given the nature of the problem and reasons for the 1940 Act's failure to remedy it, creating a corporate right of action

would have made little sense and we conclude Congress never intended to do so.[12]

III

We have not as yet considered the applicability of Rule 23.1 head-on. Instead, we posed the analytically precedent question, whether a Fund may use § 36(b), and thereby trigger the rule. Our answer, that Rule 23.1 does not apply because the Fund has no right of action, renders superfluous any extensive discussion of the policy behind requiring demand. Nonetheless, because we believe neither policy nor logic compels application of the demand requirement to actions for return of excessive adviser fees, we briefly discuss the distinctiveness of § 36(b).

Unlike the board in the common variety of derivative suit, the directors have no power to terminate a § 36(b) action. Other provisions of the Investment Company Act. *e.g.*, 15 U.S.C. § 80a-13(a)(3), governed by state rules to the extent they are not inconsistent with federal law, leave unanswered the question whether independent directors of an investment company may terminate suit. ***Burks v. Lasker, supra***, 441 U.S. at 483-86, 99 S.Ct. at 1839-1841. "[W]hen Congress . . . intend[ed] to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b) . . . , added to the act in 1970, performs precisely this function . . . ." *Id.* at 484, 99 S.Ct. at 1840 (citation omitted). Since directors cannot cut off a suit

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12 We agree with the First Circuit, ***Grossman v. Johnson, supra***, 674 F.2d at 121, that debate over the legislative history "end[s] in a draw," but we proceed under a different assumption, that § 36(b) does not permit an action by the investment company, and reach the opposite conclusion that Congress intended no demand requirement would apply.

and § 36(b) does not authorize them to institute one, and because shareholder plaintiffs are necessarily challenging fees the directors evaluated and approved, 15 U.S.C. § 80a-15; *see Rosenfeld v. Black, supra*, 445 F.2d at 1345, the traditional reason for the demand requirement simply does not apply. *See* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U.Chi.L.Rev. 168, 171-72 (1976).[13]

Moreover, although requiring demand normally imposes only minor hardship on the complaining shareholders, in a § 36(b) suit the consequences can be severe. Section 36(b) expressly limits recovery to excessive fees paid up to one year prior to the commencement of suit. 15 U.S.C. § 80a-35(b)(3). The demand requirement implies a reasonable time in which directors may analyze the issues and determine whether they believe the company has a grievance. The delay caused by this process would, in many cases,[14] have the untoward result of precluding

13 One court, analogizing *Burks v. Lasker*, concluded that the question whether a board of directors is sufficiently "interested" in the challenged transaction to excuse demand shall be resolved by reference to "the same factors used to determine whether a court should defer to the board's decision not to pursue the action" *Lewis v. Curtis, supra*, 671 F.2d at 785. Under this view, the termination and excuse issues are functions of the same indicia of "interestedness." *Burks* may be regarded as recognizing the Congressional determination that directors in § 36(b) actions are *never* sufficiently disinterested to permit them to terminate suit, 441 U.S. at 484, 99 S.Ct. at 1840. Viewing these two principles in tandem, it is possible to infer that Congress also believed directors would always be so "interested" that demand would inevitably be "excused." This is but another way of saying Congress intended that § 36(b) suits would be *exempt* from Rule 23.1.

14 At oral argument, Fox's counsel referred to the case where the fund may have awarded a substantial one-time payment for allegedly remarkable services. No doubt other examples could be cited.

full recovery of excessive fees while the directors determined whether they had acted against the interests of the shareholders in approving the contract initially. We do not believe Congress was unaware of this pitfall.

IV

In a different contest, Justice Jackson eloquently described the origin and rationale of the derivative suit:

> Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own. It required him first to demand that the corporation vindicate its own rights, but when, as was usual, those who perpetrated the wrongs also were able to obstruct any remedy, equity would hear and adjudge the corporation's cause through its stockholder with the corporation as a defendant, albeit a rather nominal one. This remedy, born of stockholder helplessness, was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses.

Cohen v. Beneficial Loan Corp., 337 U.S. 541, 548, 69 S.Ct. 1221, 1226, 93 L.Ed. 1528 (1949). In holding that a Rule 23.1 demand will not be required in a shareholder suit brought pursuant to § 36(b) of the Investment Company Act, we do not ignore the appropriateness, in the typical derivative suit alleging corporate wrongdoing, of first asking the corporation to "vindicate" what are, after

all, "its own rights." We conclude, however, that in the unique context of a § 36(b) lawsuit, the shareholder need not afford the fund an opportunity to vindicate its rights because such a requirement would be an empty, unfruitful and dilatory exercise.

The judgment of the district court is reversed and the case is remanded.

Decision of the Court of Appeals for the First Circuit in
Grossman* v. *Johnson

No. 81-1348.

United States Court of Appeals,
First Circuit.

Argued Nov. 5, 1981.
Decided March 29, 1982.

STANLEY M. GROSSMAN,

Plaintiff-Appellant,

—v.—

EDWARD C. JOHNSON, 3rd, et al.,

Defendants-Appellees.

Shareholder brought derivative action on behalf of investment fund. The United States District Court for the District of Massachusetts, Joseph L. Tauro, J., dismissed the suit, 89 F.R.D. 656, and plaintiff appealed. The Court of Appeals, Davis, Judge, sitting by designation, held that: (1) in adding amendment to Investment Company Act to prescribe separate statutory claim for excessive advisory fees to investment adviser, Congress neither repealed nor limited demand provision of rule, under which complaint to enforce right of corporation or unincorporated association must allege with particularity efforts if any made by plaintiff to obtain action he desires from directors or comparable authority and, if necessary,

from shareholders or members, and reasons for failure to obtain such action or for not making the effort; (2) where shareholder claims to be excused from compliance with such rule requirement, proper excuse of control or domination calls for particularized allegations and specific facts, and mere "participation" or "acquiescence" by directors in level of challenged advisory fees is insufficient excuse where corporate activity is normal one of setting and paying advisory fees, and allegation that directors had already announced firm opposition to suit was equally unavailable where disinterested directors' position did not preclude their first consideration of plaintiff's demand; and (3) on claim of failure to recapture excessive underwriting commissions, discounts and spreads paid by fund on its purchases of securities, shareholder's allegations of excuse for failing to make demand before bringing suit, i.e., that directors all had conflict of interest, was insufficient.

Affirmed.

Richard M. Meyer, Washington, D.C., with whom Avram G. Hammer, Boston, Mass., and Milberg, Weiss, Bershad & Specthrie, New York City, were on brief, for appellant.

James S. Dittmar, Boston, Mass., with whom Berman, Dittmar & Engel, P. C., Boston, Mass., was on brief, for appellees Edward C. Johnson, 3d, et al.

E. Milton Farley, III, Richmond, Va., with whom Sumner H. Babcock, E. Susan Garsh, Bingham, Dana & Gould, Boston, Mass., John W. Riely, Joseph C. Kearfott

and Hunton & Williams, Richmond, Va., were on brief, for appellees Dwight L. Allison, Jr., et al.

Jerome P. Facher, Boston, Mass., with whom Harry T. Daniels, James R. Gomes, Hale & Dorr, Peter M. Saparoff, and Gaston Snow & Ely Bartlett, Boston, Mass., were on brief, for appellee Fidelity Municipal Bond Fund, Inc.

Richard A. Kirby, Sp. Counsel, Washington, D. C., with whom Ralph C. Ferrara, Gen. Counsel, Paul Gonson, Sol., Edward F. Greene, Gen. Counsel, Jacob H. Stillman, Associate Gen. Counsel, Robert Mills and Louis C. Whitsett, Attys., Washington, D.C., were on briefs, for the Securities and Exchange Commission, amicus curiae.

Before CAMPBELL, and BOWNES, *Circuit Judges*, and DAVIS,* *Judge*.

DAVIS, *Judge*.

Plaintiff-appellant Stanley M. Grossman brought this derivative action in the District Court for Massachusetts, under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 *et seq.* (1976) (the Act).[1] He is and has been a shareholder of Fidelity Municipal Bond Fund, Inc. ("the Fund"), a registered open-end investment com-

* Of the United States Court of Claims, sitting by designation.

1 For the purposes of our limited disposition, we rest on facts alleged by plaintiff in his amended complaint, and merely capsule the facts and proceedings.

pany, and he sues the Fund's investment adviser, Fidelity Management & Research Company ("FMR"), the corporation that is the sole owner of that adviser ("FMR Corp."), the affiliated directors of the Fund, as well as most of the unaffiliated directors (whom we shall call "disinterested").[2] Against these defendants, Grossman makes two charges: (a) breach of fiduciary duty to the Fund with respect to the allegedly excessive amount of advisory fees paid to FMR by the Fund; and (b) breach of fiduciary duty to the Fund by failing to recapture (or have recaptured) excessive underwriting commissions, discounts and spreads paid by the Fund on its purchases of securities. Before instituting the suit, plaintiff made no demand on the Fund or its directors to bring or prosecute an action on either of these two bases.

Defendants moved to dismiss the complaint, asserting, as one point, that plaintiff had failed to comply with Rule 23.1 of the Federal Rules of Civil Procedure, governing demand by shareholders in derivative actions. During the lengthy argument on those motions, the District Court suggested that it might be advisable, it might even end the controversy, for plaintiff to send a demand letter to the directors specifying his position, although the litigation had already commenced. After consideration, plaintiff did make such demand.

The District Court then stayed action on the motion and ordered the "disinterested" directors[3] to review the

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2 The "affiliated" directors own 5% or more of the shares of FMR Corp. and are officers and directors of FMR. The "unaffiliated" directors do not have those connections with FMR and FMR Corp.

3 These were the "unaffiliated" director defendants, plus one unaffiliated director who had not been sued though he had previously

demand and report back to the court. These directors delegated responsibility to a Special Committee composed of the two directors who were not defendants (*see* note 3, *supra*). The latter retained a former Chairman of the Securities and Exchange Commission (and his outside law firm) to make a study and render a report on the issues presented by plaintiff's demand. A lengthy report was made, concluding that there had been no statutory violation or breach of fiduciary duty on either branch of the suit, and recommending that the Special Committee seek to have this suit dismissed. The Committee accepted that recommendation.

Defendants then moved to dismiss the amended compalint,[4] and, alternatively, for summary judgment, urging two grounds which the District Court considered: (a) the failure to make a proper and timely demand, and (b) the court should accept the Special Committee's good faith "business judgment" that the suit should be terminated. In the decision now before us, the District Court accepted both of these contentions, alternatively. 89 F.R.D. 656 (1981). Judgment was entered for defendants. For the reasons to be given in Parts I, II and III of this opinion, we affirm on the former ground, by-passing the latter.

I

Rule 23.1 of the Rules of Civil Procedure ("Derivative Actions by Shareholders") declares:

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joined the board, and one unaffiliated director who became a board member after the suit had been brought (and accordingly was not sued).

4 In the course of the proceedings plaintiff had been permitted to file an amended complaint.

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Plaintiff urges that Rule 23.1 is wholly inapplicable to that portion of his case charging the payment of excessive advisory fees to the investment adviser (FMR), which is brought under the special provisions of section 36(b) of

the Act, 15 U.S.C. § 80a-35(b)(1976). In this segment of our opinion we consider that contention.[5]

Section 36(b), added in 1970, prescribes a separate statutory claim for excessive advisory fees to an investment adviser.[6] The Securities and Exchange Commission

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5 Plaintiff also says that, even if Rule 23.1 applies, he was excused from making a demand on the directors for this aspect of his complaint. We discuss that point in Part II, *infra*. As for the recapture of commissions, Grossman does not argue that Rule 23.1 is wholly inapplicable; he mainly says, instead, that he was excused from making a demand. We also consider that argument in Part II, *infra*. On both sectors of his case, plaintiff insists, in addition, that the demand he made after the beginning of the suit was adequate compliance with Rule 23.1. Part III, *infra*, deals with that premise.

The Securities and Exchange Commission, which participated in this appeal as amicus curiae, takes no position on the applicability of the demand provisions of Rule 23.1 or the alleged excuses for noncompliance.

6 The relevant parts of section 36(b) read:

> "(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments [including directors], for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:
>
> (1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

and security holders of the investment company are specifically authorized to sue "on behalf of such company" to recover such fees. The section (among other limitations) places on the plaintiff the burden of proof of showing a breach of fiduciary duty, restricts monetary relief to actual damages and to the persons receiving such compensation, establishes a one-year statute of limitations on recovery, and provides that approval or ratification by the paying company's directors of the compensation to the investment adviser "shall be given such consideration by the court as is deemed appropriate under all the circumstances."

There is no express reference to Rule 23.1 or to demand by the suing shareholder, but plaintiff gives several reasons why, in his view, the structure, terms, and purpose of the provision show that the Rule is wholly inapplicable to such excessive fee suits. We divide these arguments into

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(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient."

three groups, first, those that we believe to have little merit, second, those that have substantial weight but are subject to countervailing arguments which likewise have merit, and then we discuss the considerations we believe to tip the balance against plaintiff on this question.

A.1. Appellant says initially that Rule 23.1 must be wholly inapplicable because, though the statute says that suit must be brought on behalf of the investment company and in that sense is a "derivative" action, section 36(b) does not permit an action by the investment company itself (but only by the SEC or a security holder).[7] We cannot believe, however, that, for example, a new and independent board of directors, intent on recovering excessive fees from the investment adviser, would be precluded from suing under section 36(b).[8] That section is explicit that recovery by a shareholder is to be on behalf of the investment company and that his suit must be brought on the same behalf. With those clear requirements, Congress could well have believed that, though it was appropriate to specify that the Commission and shareholders had the new statutory cause of action under section 36(b), *see Moses v. Burgin*, 445 F.2d 369, 373 n.7 (1st Cir. 1971), it was unnecessary to say with particularity that the company also did. A suit "on behalf of such

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7 The first sentence of Rule 23.1, *supra*, requires that "the corporation or association [shall have] failed to enforce a right *which may properly be asserted by it*" (emphasis added).

8 One reason why the directors might wish to use section 36(b), instead of employing a more conventional corporate suit, is that subsection (1) expressly removes the need to allege or prove "personal misconduct" on the part of any defendant. In addition, the general standard for recovery might be easier under section 36(b) than in a non-statutory action.

company" (a phrase which is more than merely one "for the benefit of the company") is normally a derivative action that the company could itself bring.

Plaintiff, whose complaint and amended complaint both allege that he brings this action "derivatively on behalf of the Fund," seems to have originally agreed that his suit under this section could have been brought by the Fund. Although subsection (3) directly forbids an action under section 36(b) against any person "other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments"—barring as defendants, in this instance, the "disinterested" directors and the Fund itself—this whole proceeding (including that part under section 36(b)) was brought against those "forbidden" defendants,[9] apparently on the correct assumption that this is a derivative suit to enforce rights the Fund could itself enforce, and in which the company and its directors should be joined in the ordinary fashion.

2. Another of plaintiff's points we reject outright is the analogy to section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1976) ("profits from purchase and sale of security within six months"), which has been held excluded from certain non-demand parts of Rule 23.1. *Dottenheim v. Murchison*, 227 F.2d 737, 739-741 (5th Cir. 1955), *cert. denied*, 351 U.S. 919, 76 S.Ct. 712, 100 L.Ed. 1451 (1956); *Blau v. Mission Corp.*, 212 F.2d 77, 79 (2d Cir.), *cert. denied*, 347 U.S. 1016, 74 S.Ct. 872, 98 L.Ed. 1138 (1954). On the demand point, however, section 16(b) is plainly inapposite because it embodies its

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9 This is also true of the amended complaint.

own express demand requirement different from that in Rule 23.1.[10] If anything, that special demand provision indicates that Congress considered a demand essential for a shareholder suit even though Congress may have dispensed with other aspects of what is now Rule 23.1.

3. A related argument we cannot accept is that section 36(b) speaks of suit by a "security holder", a term which it is said could cover pure debenture holders or other bare creditors who, not being shareholders or members, cannot comply with the demand aspects of Rule 23.1 The simple answer, we think, is that Congress used the general term "security holder" in section 36(b) to cover shareholders of mutual funds and like investors akin to stockholders, whom Rule 23.1 undoubtedly fits. The phrase was not designed to allow mere creditors to make use of section 36(b).[11]

B. Plaintiff makes three stronger arguments for total exclusion of the demand requirement of Rule 23.1—but each seems to us to have a substantial counterbalance.

1. Grossman's chief claim .. that a demand would be futile because the directors, even the "disinterested" ones, cannot by themselves terminate a section 36(b) suit

10 Suit may be brought "if the user shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter * * * " 15 U.S.C. § 78p(b).

11 The legislative history of § 36(b) speaks of suits thereunder by "shareholders". *See* S.Rep.No. 184, 91st Cong., 1st Sess., *reprinted in* [1970] U.S.Code Cong. & Ad.News 4897, 4910; H.R.Rep.No. 2337, 89th Cong., 2d Sess. 143, 146 (1966) (SEC report); 115 Cong.Rec. 13699 (1969); *Investment Company Act Amendments of 1969: Hearings of the Senate Committee on Banking and Currency*, 91st Cong., 1st Sess. 1-2 (1969).

through the good faith exercise of reasonable "business judgment". We do not today decide whether or not the directors are so disabled—but it is undeniable that there are very serious reasons for accepting that proposition. *Burks v. Lasker,* 441 U.S. 471, 484, 99 S.Ct. 1831, 1840, 60 L.Ed.2d 404 (1979), a case on the directors' power to terminate a suit under other portions of the Act where section 36(b) was not involved, expressly contrasted the latter provision: "And when Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b), 84 Stat. 1428, 15 U.S.C. § 80—a—35(b)(2), added to the Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees."[12] The Supreme Court was referring to § 36(b)(2) (note 6, *supra*) which can easily be read to give the court, rather than the directors, the ultimate power to decide the propriety of the fees.

Nevertheless, even on that interpretation of the statute, a demand would not be futile. It would give the independent directors the opportunity to study the problem and decide whether to accede, in whole or in part, to the complainant's views. When it added § 36(b), Congress also deliberately strengthened the position of independent directors, including their dealing with advisory fees. *See Burks v. Lasker, supra,* 441 U.S. at 482-485, 99 S.Ct. at 1839, 1840-1841. They were not designed to be ciphers or to be overlooked. Although the court would decide for itself (on the view we accept *arguendo*) the merits of the

12 Though this statement may technically have been "dictum" in the sense that *Burks* did not itself involve section 36(b), the Court's observation formed an integral part of its reasons for holding that the directors had broader powers under other parts of the Act. The statement was by no means gratuitous or *obiter.*

claim of excessive compensation, the independent and disinterested directors still have a substantial role. Surely, their decision to side with the complainant (entirely or in part) would have important consequences, and even their knowledgeable disagreement with the demand might be deemed worthy by the court of grave consideration under § 36(b)(2).

2. Plaintiff's appeal to the legislative history (of the 1970 amendments) to show that section 36(b) was exempted from the demand requirement of Rule 23.1 seems, at the very best for him, to end in a draw. There was, as he points out, emphasis on the prior ineffectiveness of independent directors with respect to advisory fees, the need for strengthening then section 36, and the significant role of the courts in determining the proper level of fees. *See* the *S. E. C. 1966 Report on Investment Companies,* H.R.Rep. No. 2337, 89th Cong., 2d Sess., 131, 143, 146 (1966); *Investment Company Act Amendments of 1960: Hearings of the Senate Committee on Banking and Currency,* 91st Cong., 1st Sess. 1-2 (1969); S.Rep. No. 184, 91st Cong., 1st Sess., 2, 6-7, *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4898, 4903; 115 Cong.Rec. 13699 (1969). But these themes are all fully consistent with the continued operation of the demand part of Rule 23.1, which would not impede or contradict any of the stated purposes. Indeed, the history shows an equal and concurrent stress on the authority and responsibility of the directors. S.Rep. No. 184, 91st Cong., 1st Sess. 7, *reprinted in* [1970] U.S. Code Cong. & Ad.News 4897, 4903. ("The section [section 36(b)] is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders

from the directors of such company to the judiciary"; and "the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors"). At the same time, there was a concern to discourage unjustified derivative suits. H.R.Rep. No. 1382, 91st Cong., 2d Sess. 8 (1970); *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce,* 91st Cong., 1st Sess. 201, 662, 860 (1969). That aim is closely connected with Rule 23.1, which has such a goal among its functions.

When the inquiry narrows down to the continued relevance of the Federal Rules, especially Rule 23.1, there is some direct indication that the Rules were or may have been regarded as barriers to unjustified derivative suits. The Chairman of the Securities and Exchange Commission so reported. *Id.* at 201 (" * * * there are adequate safeguards under the Federal Rules of Civil Procedures [sic] and under this bill to prevent unjustified shareholder litigation"); to the same effect, *see id.* at 860, where the Chairman specifically mentioned "*e.g.* Rule 23, FRCP" as one of the "sufficient safeguards against frivolous or harassing lawsuits." Plaintiff cites a comment of another Commissioner disfavoring "the interposition of procedural obstacles", *Investment Company Act Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency,* 91st Cong., 1st Sess. 30 (1969), but this was a reference, not to the demand requirement of Rule 23.1, but to a proposed provision that a suing shareholder must own a specified percentage of stock or represent a stated amount of the investment fund's assets.

3. Lastly, plaintiff invokes the short one-year limitation period on damages[13] as sufficient reason for exempting § 36(b) cases from the demand provision of Rule 23.1—the time taken by demand-and-response before institution of an action would, it is argued, diminish the period and the amount of recovery. The truth is, however, that ordinarily the demand requirement could change the particular one-year period for which recovery was allowable but would not reduce the one-year recovery period, and probably not decrease the amount. In the unusual case in which the amount of recovery could actually be reduced by directors' dawdling or the taking of excessive time to reply to a demand, a district court could allow suit to go forward without awaiting a response. *See Mills v. Esmark, Inc.*, 91 F.R.D. 70, 73 (N.D.Ill.1981).

C. The residue of our discussion (to this point) is that there is no strong reason for wholly excluding section 36(b) from the demand requirement, or for thinking that Congress intended that result. In subpart A, *supra*, we have rejected some of plaintiff's contentions outright, and in subpart B we have found that each of his more substantial points has a fair and equivalent counterpoise. The decisive factor, we must conclude, is that there is no persuasive indication that, in adopting section 36(b), Congress wished to repeal or limit the demand provision of Rule 23.1 which has long been a general part of our federal law of practice and procedure, governing almost all derivative actions in federal courts.

In the absence of a "clear inconsistency" or a demonstrated congressional purpose to exclude one or more of

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13 Section 36(b)(3) (note 6, *supra*) provides: "No award of damages shall be recoverable for any period prior to one year before the action was instituted."

the Federal Rules, "a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible." 7 Moore's Federal Practice, ¶ 86.04[4] at 86-22 (2d ed. 1980); *United States v. Gustin-Bacon Division, Certain-Teed Products Corp.*, 426 F.2d 539, 542 (10th Cir.), *cert. denied,* 400 U.S. 832, 91 S.Ct. 63, 27 L.Ed.2d 63 (1970); *see also,* 4 C. Wright & A. Miller, Federal Practice & Procedure, § 1001 at 30-31 (1969 ed.)[14] That harmonization is quite feasible for section 36(b). Perhaps for such actions the demand requirement of Rule 23.1 may tend toward the status of a legal vermiform appendix—the provision's utility may be reduced sharply in § 36(b) litigation—but the demand requirement still has a function to perform and is not totally without purpose or effect. In those circumstances it is not for the courts to hold inapplicable the demand requirement "which continues a long tradition in the federal courts," *Heit v. Baird,* 567 F.2d 1157, 1160 (1st Cir. 1977), where Congress has not done so, explicitly or by solid implication.[15]

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14 Compare this principle with the canon against implied repeals of the statutes in the absence of clear intention to do so or repugnancy of the later to the earlier legislation. *Morton v. Mancari,* 417 U.S. 535, 551, 94 S.Ct. 2474, 2483, 41 L.Ed.2d 290 (1974); *Georgia v. Pennsylvania R. R.*, 324 U.S. 439, 456-57, 65 S.Ct. 716, 725-726, 89 L.Ed. 1051 (1945).

15 In *General Telephone Co. v. EEOC*, 446 U.S. 318, 100 S.Ct. 1698, 64 L.Ed.2d 319 (1980), the Supreme Court ruled—on the basis of a "straightforward" reading of § 706 of the Civil Rights Act of 1964, the legislative intent underlying the 1972 to Title VII, and the enforcement procedures under Title VII—that the EEOC's enforcement action was not properly characterized as a "class action" subject to the procedural requirements of Rule 23. As we have said, comparable factors are absent here.

In addition to the court below, three district courts have passed directly on the applicability of the demand requirement of Rule 23.1

II

If, as we have held in Part I, *supra*, a § 36(b) action is not exempt from the demand portion of Rule 23.1, we must confront Grossman's secondary argument that, in any event, he was excused (as to the 36(b) portion of his suit) from making demand. He takes a parallel position for the "recapture" part of his action (which is not brought under § 36(b) and as to which plaintiff makes no claim of a complete exemption from the Rule). Rule 23.1 mandates that the complaint "shall also allege with particularity the efforts, if any, made by plaintiff to obtain the action he desires from the directors * * * and the reasons for his failure to obtain the action or for not making the effort." In this circuit that requirement has been "vigorously enforced." *Heit v. Baird, supra,* 567 F.2d at 1160. "The futility of making the demand required by Rule 23.1 must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight." *Cramer v. General Telephone & Electronics Corp.,* 582 F.2d 259, 276 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979).

1. On the advisory fees (the § 36(b) claim), plaintiff's only excuses are that the Fund's directors were controlled by or affiliated with FMR, had participated in the alleged

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to suits under section 36(b). Two have held Rule 23.1 applicable. *Markowitz v. Brody,* 90 F.R.D. 542, 548-49, 554-55, 559-61 (S.D.N.Y. 1981); *Weiss v. Temporary Investment Fund, Inc.,* 516 F.Supp. 665, 668-70 (D.Del. 1981), *rehearing denied,* 520 F.Supp. 1098 (1981). One court held primarily that demand was futile in that instance and therefore excused under Rule 23.1, but was also "inclined to agree with plaintiffs that a demand on the directors of the Fund was not intended to be a prerequisite to suit under § 36(b)." *Blatt v. Dean Witter Reynolds Intercapital, Inc.,* S.D.N.Y., 528 F.Supp. 1152 (1982).

wrong, and had announced their opposition to the suit. All three reasons are inadequate. Of the eight Fund director-defendants, only three were affiliated with FMR; five were unaffiliated and "disinterested."[16] As the court said in *Untermeyer v. Fidelity Daily Income Trust*, 580 F.2d 22, 23 (1st Cir. 1978), and *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 264 (1st Cir.), *cert. denied*, 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973), a majority of disinterested directors negatives general allegations of control-by-the-adviser, comparable to those plaintiff makes here. A proper excuse of control or domination calls for particularized allegations and specific facts—which are absent both in the initial and the amended complaint.

As for mere 'participation" or "acquiescence" by the directors in the level of the challenged advisory fees, that generality, too, is an insufficient excuse where the corporate activity is the normal one of setting and paying advisory fees; on this point, there also are no particulars asserting that a majority of the directors engaged in a "facially improper transaction." Bare allegations of "wrongful participation" or "acquiescence" are not enough in this circuit. See *In re Kauffman Mutual Fund Actions, supra*, 479 F.2d at 264-65; *Heit v. Baird, supra*, 567 F.2d at 1160-62.

The third allegation, that the directors had already announced their firm opposition to the suit, is equally unavailing. Apart from the critical fact that the statement on which plaintiff relies in his amended complaint did not precede the suit but was part of a motion to dismiss the initial complaint, there is no doubt whatever that, in

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16 One disinterested director (who was apparently such at the time suit was begun) was not sued.

context, the disinterested directors' position did not preclude their fair consideration of plaintiff's demand.[17]

2. The primary excuse for failing to make demand on the "recapture" element of the case is that the directors all had a conflict of interest.[18] The gist of this claim is that FMR should have recovered a substantial portion of underwriting commissions, discounts and spreads paid on the Fund's purchases of municipal bonds, but failed to do so "because FMR received from the underwriters substantial benefits in the form of research, statistical and other information in connection with FMR's functions as investment adviser *to the other funds which it manages*" (emphasis added). The posited conflict-of-interest arises because all the Fund's directors are directors or trustees of other funds managed by FMR, and as such directors or trustees (it is asserted) would have an interest adverse to recapture for the Fund, so that the other funds could continue to receive the information they need and want.

We can assume *arguendo* that there might arguably be some duty to recapture as charged in the complaint, but the difficulty with plaintiff's general assumption of "conflict of interest," as an excuse for not making demand, is

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17 The full statement was: "The Disinterested Directors have no basis for believing that suit against FMR for the practices alleged in the Complaint is justified. They are anxious, however, to evaluate any information which Grossman has which suggests that it is. If they concluded that suit is justified, the Fund's best interests demand that they bring suit. They will do so."

As ground for his excuse, Grossman quotes only the first sentence, omitting the remainder.

18 Plaintiff also says, on this phase, that the directors had announced their firm opposition to the merits of his recapture claim. On that, the answer we have already given (*see* note 17, *supra,* and text) suffices.

that he fails to set forth with any specificality, as Rule 23.1 and our decisions require, the factual grounds why this putative "conflict of interest" was in fact an actual one. The conflicting status of the Fund's directors here was at best tenuous and conditional, not direct, stark, apparent and "unmistakable" as in *Delaware & Hudson Co. v. Albany & Susquehanna Railroad,* 213 U.S. 435, 29 S.Ct. 540, 53 L.Ed. 862 (1909). The responsibility both for supplying the information to the other funds and for recapture was, not on the other funds, but on FMR, with which a majority of the Fund's board were unconnected. The same is true of the financial detriment of recapture, which would fall on FMR; the other funds would not be interested in that money. They may be concerned with continuing to receive the information,[19] but there is no allegation or reason to believe that they would not be satisfied if FMR obtained it elsewhere than from underwriters, brokers or dealers. Although there is an allegation that recapture would diminish the amount of information supplied by the latter, there is no assertion that FMR (which had the duty to supply it) would not be able to, or would not, fill the gap from another source, nor is there any assertion that the other funds would have to pay FMR higher fees in order to obtain the information they wanted. To charge a true conflict of interest the plaintiff should have at least spelled out the likelihood of one, not left the court with the bare possibility that the defendants might conceivably have the incentive to vote or push against recapture because of their interests as directors of the other funds. *Heit v. Baird, supra,* 567 F.2d at 1161-62, indicates tht the bare possibility or mere

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19 There are, however, no particularized allegations on the necessity or importance of the other funds' continuing to receive the information.

allegation that the directors could have a self-interested purposed (there, to retain control of the corporation; here, to advance the interests of the other funds) is not enough if, as in this case, there can be valid corporate reasons for taking the position challenged in the complaint—or if there is in fact no conflict because of other circumstances not negated by plaintiff. Conversely, "the antagonism between the directory and the corporate interest" must be shown to be "unmistakable," or deemed futile, to excuse demand. *Delaware & Hudson Co. v. Albany & Susquehanna Railroad,* 213 U.S. 435, 447, 29 S.Ct. 540, 543, 53 L.Ed. 862 (1909); *In re Kauffman Mutual Fund Actions, supra,* 479 F.2d at 263.

III

The final question is whether plaintiff's post-litigation demand cured his failure to make one before beginning the action. Rule 23.1 specifically calls upon the complaint to show that demand was made or was properly excused; there is no provision for thereafter remedying an omission in the same suit, especially after the defendants have moved to dismiss because of the absence of a demand. The terms of the Rule have generally been followed by other appellate courts. *Lucking v. Delano,* 117 F.2d 159, 160 (6th Cir. 1941) ("Obviously the filing of the complaint cannot be regarded as a demand to sue, for by starting the action [plaintiffs] have usurped the field"); *Shlensky v. Dorsey,* 574 F.2d 131, 141-42 (3rd Cir. 1978) ("The contemplated showing of demand made upon the directors after the filing of the shareholders' derivative complaints could not have satisfied the demand requirements of the rule"); *Galef v. Alexander,* 615 F.2d 51, 59 (2d Cir. 1980) ("Rule 23.1 * * * is essentially a requirement that a

stockholder exhaust his intracorporate remedies before bringing a derivative action").

Though this court has not yet ruled squarely on the precise point, it has observed that the rule of demand is to alert the director before suit is instituted. *In re Kauffman Mutual Fund Actions, supra,* 479 F.2d at 263, we said that "to be allowed, sua sponte, to place himself in charge without *first* affording the directors the opportunity to occupy their normal status, a stockholder must show that his case is exceptional," *i.e.* that demand is excused (emphasis added). The same postulate was expressed in *Heit v. Baird, supra,* 567 F.2d at 1162 (n.6): "The purpose of the demand requirement is, of course, to require resort to the body legally charged with conduct of the company's affairs *before* licensing suit in the company's name by persons not so charged" (emphasis added). Under this court's practice of vigorous enforcement of the Rule (*Heit v. Baird,* 567 F.2d at 1160; *see also In re Kauffman Mutual Fund Actions,* 479 F.2d at 263, 267), and of the generally "strict view" the court takes "of the requirement of prior demand" (*Untermeyer v. Fidelity Daily Income Trust,* 580 F.2d 22, 23 (1st Cir. 1978)), these statements should be, and are, now embodied in an explicit holding.

It makes no difference that in this instance the belated demand was made at the suggestion of the District Court. The judge's colloquy with counsel shows that the court was simply making that suggestion, as the opinion below says, "in the hope that expensive and lengthy litigation could be avoided"; if the directors responded favorably to plaintiff, in whole or in part, that would clearly be the result. Grossman then made his demand voluntarily, with his expressed understanding "that the demand letter

would not be deemed a waiver by any party of rights which it otherwise possessed." There was no direction by the court and no agreement that the late demand would rectify the initial failure to make a demand prior to suit.

IV

Because we hold that the suit must be dismissed because plaintiff did not make the necessary demand before suing, we refrain from considering the District Court's alternative holding that, in any event, defendants are entitled to judgment on the ground that their "alleged actions are protected by and comply with the requirements of the business judgment rules."

Affirmed.

Decision of the Court of Appeals for the Third Circuit in
Weiss* v. *Temporary Investment Fund

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-2688

MELVYN I. WEISS, Custodian for
GARY MICHAEL WEISS, U/NY/UGMA,
Appellant

v.

TEMPORARY INVESTMENT FUND, INC., PROVIDENT INSTITUTIONAL MANAGEMENT CORPORATION, SHEARSON LOEB RHOADES, INC., RUSSELL W. RICHIE, ROBERT R. FORTUNE, JAMES LOUIS ROBERTSON, HENRY M. WATTS, JR., DR. RALPH A. YOUNG, THOMAS S. GATES, G. WILLING PEPPER
Appellees

(D.C. Civil No. 80-00230)

ON APPEAL FROM THE UNITED STATES DISTRICT
COURT FOR THE DISTRICT OF DELAWARE

Argued April 2, 1982

Before: GIBBONS, SLOVITER and
BECKER, *Circuit Judges*

(Opinion Filed November 12, 1982)

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OPINION OF THE COURT

BECKER, *Circuit Judge.*

The principal question presented in this appeal is whether a shareholder of an investment company must make a demand on directors pursuant to Fed. R. Civ. P. 23.1 prior to commencing suit under section 36(b) of the Investment Company Act of 1940 (ICA), 15 U.S.C. §§80a-35(b) (1976), to challenge the company's contracts with its investment advisers. The district judge dismissed the action for failure to satisfy the demand requirement, *Weiss v. Temporary Investment Fund, Inc.*, 516 F. Supp. 665 (D. Del. 1981), and denied the appellant leave to replead after making a demand, *Weiss v. Temporary Investment Fund, Inc.*, 520 F. Supp. 1098 (D. Del. 1981).

Appellant Weiss contends that the ICA was a product of Congress' recognition of potential conflicts of interest in the management of investment companies and that the ICA's legislative history and statutory scheme, which reflect that concern, are inconsistent with the re-

quirement of shareholder demand. After reviewing that legislative history and statutory scheme and the purposes of the demand requirement, we perceive no such inconsistency. We conclude that the contributions of the demand requirement to corporate governance mandate application of Rule 23.1 to section 36(b) suits. We also conclude that the circumstances alleged in the complaint do not warrant excusing such a demand as futile, and the district judge did not err in denying leave to replead. We therefore affirm.

I. *INTRODUCTION*

A. *Factual and Procedural Background*

Plaintiff-appellant Melvyn I. Weiss, as custodian for his son Gary Michael Weiss, is a shareholder of the Temporary Investment Fund, Inc. (the Fund). The Fund is a no-load open-end investment company, commonly referred to as a "money market fund," whose objective is to increase the current income of its shareholders through investments in a variety of prime money market obligations. The Fund is managed by a seven-member board of directors elected by its shareholders.[1]

Under an Advisory Agreement, the management of the Fund's portfolio is entrusted to its investment adviser, Provident Institutional Management Corporation (the Adviser), a wholly-owned subsidiary of Provident National Bank (Provident). Under a sub-advisory agreement, Provident receives seventy-five percent of the Adviser's fees, in return for which it supplies, *inter alia*, investment research services, computer facilities, and operating personnel. Shearson Loeb Rhoades, Inc. (Shearson) serves as underwriter for the Fund and performs other administrative functions under its Administration and Distribution Agreement with the Fund.

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1. In January 1980, when the advisory contracts at issue were approved, the board consisted of six members.

The terms of the Advisory and Administration Agreements (collectively referred to as "advisory contracts") provide that the fees received by the Adviser and Shearson are computed as a percentage of the Fund's assets. The percentage rate is scaled downward: Shearson and the Adviser each received .175 percent of the first $300 million in assets, .15 percent of the next $300 million, and .125 percent of the third $300 million. For average net assets in excess of $900 million, the rate is fixed at .1 percent. The recent popularity of money market funds has dramatically increased the Fund's assets, to more than $2 billion when suit was commenced in 1980. This phenomenon has produced a commensurate increase in the fees received by the Adviser and Shearson.

On May 7, 1980, Weiss brought a shareholder suit on behalf of the Fund against the Adviser, Shearson, and seven directors of the Fund. One count of the complaint charges that Shearson and the Adviser breached their fiduciary duties to the Fund under section 36(b) of the ICA by receiving "excessive and unreasonable" compensation. The basis of this count is the advisory contracts, which Weiss contends permit the Adviser to receive twenty-five percent of the fees without performing any services and fail to provide for any reduction in fees after the Fund's assets exceed $900 million. Additional counts allege that all defendants breached their fiduciary duties by participating or acquiescing in the advisory contracts; that shareholder approval of the fee arrangements was secured through misleading proxy statements in violation of section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78n(a) (1976); and that the management and fee arrangements violate the Banking Act of 1933, 12 U.S.C. §§24, 378(a) (1976), the ICA, and common law fiduciary duties. As relief, the plaintiff sought a judgment declaring the Advisory Agreement and the Distribution Agreement void, an or-

der requiring that the Adviser and Shearson repay all excessive fees to the Fund, and an order requiring the individual defendants to reimburse the Fund for damages caused by their violations of the ICA and the Securities Exchange Act.

The complaint acknowledges that no demand was made on the directors of the Fund. It asserts, however, that demand is not a prerequisite for the section 36(b) count and that demand would have been futile as to all counts because the directors are controlled by the Fund's advisers and because they participated in the alleged violations. Amended Complaint at ¶37.

The defendants moved to dismiss the complaint on a number of grounds, including the plaintiff's failure to satisfy the Rule 23.1 demand requirement. The district court, concluding that demand is required for a section 36(b) suit and was not excused as futile, dismissed the complaint.[2] Having determined that intra-corporate remedies should be exhausted first, the court found it unnecessary to address the other challenges to the complaint. The court subsequently denied Weiss' motion seeking leave to make a demand on the directors and to file an amended complaint if demand was refused. Weiss appeals from all three rulings.

As we indicated at the outset, section 36(b) is the principal focus of our attention. Its relevant portions are set forth in the margin.[3] Although section 36(b) does not

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2. The court also dismissed the action against defendant James L. Robinson for insufficient service of process. That portion of the district court's order has not been appealed.

3. Section 36(b) provides, in relevant part:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such in-

explicitly excuse shareholders from the demand requirement of Rule 23.1, Weiss advances two theories to support his position that demand is not required. First, he argues that because the statute does not authorize a cause of action by the corporation, a section 36(b) suit is not derivative and is thus not governed by Rule 23.1 at all. Alternatively, he asserts that the legislative history and the statutory scheme supersede the policies underlying the requirement of shareholder demand. Although he presents a number of discrete arguments to support this latter thesis, their common predicate is that Congress, perceiving directors of investment companies to be ineffective checks on advisory fee levels, structured section 36(b) to permit shareholders to bypass the directors. Before considering Weiss' specific contentions, we must describe the contours of section 36(b) and other relevant provisions of the ICA.

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vestment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or ap-

B. *The Statutory Scheme*

The management of an investment company is distinguished by its reliance on external management and investment advisers. *See, e.g., Burks v. Lasker*, 441 U.S. 471, 480-85 (1979); *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977); Note, *Mutual Fund Independent Directors: Putting a Leash on the Watchdogs*, 47 Fordham L. Rev. 568 (1979) [hereinafter cited as Fordham Note]. Typically, an external organization such as Shearson creates the investment fund and appoints the initial board of directors. The board then enters into a contract with one or more external companies who manage the fund and provide investment services. In addition to receiving fees for these two functions (which may be performed by the same outside adviser), the independent advisers may receive underwriting fees or brokerage commissions if they also serve in those capacities. This web of financial ties among the fund and its advisers invites several con-

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NOTE — (*Continued*)

> proval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.
>
> (3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

15 U.S.C. §80a-35(b) (1976).

flicts of interest. In negotiating advisory fees, for example, directors affiliated with the adviser face the competing interests of the adviser, who seeks high fees, and the investors, who want low fees in order to maximize their return on investment. Similarly, an adviser who also serves as broker has an incentive to increase its fees through frequent portfolio transactions that may dissipate the earnings of the investors. *See* Fordham Note, *supra* p. 7, at 570-71.

The ICA was intended to minimize the potential conflicts arising from the creation, sale, and management of an investment company such as a mutual fund by external investment advisers. S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901. As originally enacted in 1940, the ICA's principal device to prevent self-dealing by the directors was the requirement that at least forty percent of the board members be independent — that is, that they have neither a direct nor an indirect financial interest in the company or its adviser. 15 U.S.C. §80a-10(a) (1976). Over time, however, it became apparent that this safeguard was insufficient to stem the burgeoning advisory fees. Recognizing that a company's dependency on its adviser limited the influence of arms-length bargaining in keeping advisory fees competitive, Congress enacted section 36(b) as part of the 1970 amendments to the ICA. That section imposes on the adviser a fiduciary duty with respect to compensation for its services and explicitly authorizes suits by the Securities and Exchange Commission and the fund's shareholders to enforce that duty. By increasing the standard of care owed by the advisers, Congress sought to ease the difficult burden faced by shareholders trying to prove that advisory contracts violated common law prohibitions against "corporate waste." *See infra* note 9. The remedy under 36(b) is an action against the recipient of the allegedly excessive payments for actual damages resulting from the breach of fiduciary duty, not to exceed actual pay-

ments received from the investment company. A showing of personal misconduct by the defendant is not required. The recovery of excessive fees is limited to those paid by the investment company during the one-year period prior to initiation of the suit.

Additional responsibility for monitoring management fees were also imposed on directors. The 1970 amendments require directors to investigate and evaluate advisory fee contracts, demand that a majority of disinterested directors approve the contracts, and permit the directors to terminate contracts without financial penalty upon sixty days' notice. 15 U.S.C. §80a-15(c) (1976). The amendments also tightened the qualifications of the independent directors serving on the board. *Id.* §§80a-2(19), 80a-10a.[4] The essence of the amendments, as the Supreme Court has noted, is to place these unaffiliated directors in the role of "independent watchdogs" charged with supervising the management of the company. *Burks v. Lasker, supra*, 441 U.S. at 484.

With this background in mind, we turn to Weiss' arguments that suits under section 36(b) are not subject to Rule 23.1.

II. *IS A SECTION 36(b) ACTION DERIVATIVE?*

Before addressing the arguments set forth in the briefs, we must consider a threshold contention — advanced by Weiss for the first time at oral argument — that a shareholder suit under section 36(b) is not a derivative action and thus is not subject to Rule 23.1.[5]

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4. Independent directors are those who are not "interested" in the company or its advisers. The amendments define "interested person" to include persons who have close family ties or substantial financial or professional relationships with the investment company or its advisers, or who have beneficial or legal interests in securities issued by the adviser or underwriter.

5. The belated nature of this argument is evidenced by Weiss' pleadings, which characterize the action as one brought "derivatively on behalf of the Fund." Amended Complaint at ¶2(b).

Weiss apparently relies on the rule's requirement that the right enforced by a shareholder be one which "may properly be asserted" by the corporation.[6] The ICA, however, explicitly authorizes suits only by the SEC and by the shareholders and does not state that the Fund itself may sue its advisers for breach of fiduciary duties. If the Fund cannot sue, Weiss' theory proceeds, then a section 36(b) cause of action does not derive from a right that "may properly be asserted" by the Fund. We disagree.

We can approach this issue in several ways. One approach, adopted by the First Circuit in *Grossman v. Johnson*, 674 F.2d 115 (1st Cir. 192), *cert. denied*, 51 U.S.L.W. 3245 (U.S. Oct. 5, 1982), views an investment company's right to sue its advisers as a necessary, if not explicit, corollary of the right of action conferred on shareholders by section 36(b). In holding that an investment company has a direct cause of action under section 36(b), the *Grossman* court stated:

> We cannot believe . . . that, for example, a new and independent board of directors, intent on recovering excessive fees from the investment adviser, would be precluded from suing under section 36(b). That section is explicit that recovery by a shareholder is to be on behalf of the investment company and that

6. Rule 23.1 states in pertinent part:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation, . . . the corporation . . . having failed to enforce a right which may properly be asserted by it, the complaint shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and the reasons for his failure to obtain the action or for not making the effort.

The Rule establishes other derivative suit requirements such as contemporaneous ownership of stock by the plaintiff when the alleged wrong occurred. These additional requirements are not at issue in this appeal and references here to "Rule 23.1" are limited to the demand requirement unless otherwise noted.

> his suit must be brought on the same behalf. With those clear requirements, Congress could well have believed that, though it was appropriate to specify that the Commission and shareholders had the new statutory cause of action under section 36(b), *see Moses v. Burgin*, 445 F.2d 369, 373 n.7 (1st Cir. 1971), it was unnecessary to say with particularity that the company also did. A suit 'on behalf of such company' (a phrase which is more than merely one 'for the benefit of the company') is normally a derivative action that the company could itself bring.

Id. at 120 (footnotes omitted).[7] Along similar lines, the Supreme Court noted in *Burks v. Lasker, supra*, 441 U.S. at 477, that "[a] derivative suit is brought by shareholders to enforce a claim *on behalf of* the corporation" (emphasis supplied), and the Court thereafter referred without comment to a section 36(b) suit as derivative, *id.* at 484.

We agree with the First Circuit's reasoning as far as it goes, but we expand our analysis to consider the test enunciated in *Cort v. Ash*, 422 U.S. 66 (1975). *Cort* provides the generally accepted framework for determining whether a statute creates an implied right of action.[8]

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7. The Second Circuit has rejected this argument. Fox v. Reich & Tang, Inc., No. 82-7296 (2d Cir. October 26, 1982); *see infra* pp. 13-14.

8. We recognize that implication of the corporation's right of action by a statute expressly authorizing suit by shareholders is somewhat atypical of the cases employing the *Cort* test. Three recent Supreme Court opinions illustrate the usual application of the *Cort* test in situations where the statute fails to specify either a private remedy or a cause of action for the particular relief sought. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 102 S. Ct. 1825 (1982) (finding private rights of action for violations of the Commodity Exchange Act); Middlesex County Sewerage Authority v. National Sea Clammers Ass'n, 453 U.S. 1 (1981) (finding no implied private right of action for damages under the Federal Water

Our application of the *Cort* test leads us to the same conclusion as the First Circuit.

Cort counsels consideration of four factors:

> First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,' — that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law.

Cort v. Ash, supra, 422 U.S. at 78 (citations omitted). With respect to the first factor, we have no difficulty in concluding that an investment company is the intended beneficiary of section 36(b). The legislative history states that the fiduciary duty imposed on advisers, one of the major innovations of the statute, is owed to the company itself. S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4902. Moreover, as Weiss concedes, any recovery obtained in a shareholder suit reverts to the investment company and not to the plaintiff.

The second factor, ascertainment of Congress' intent, is the principal focus of the *Cort* inquiry. *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 102 S. Ct. 1825, 1839 (1982); *see Walck v. American Stock Exchange, Inc.*, No. 82-1051, slip op. at 6, 10 (3d Cir. Sept.

Pollution Control Act or the Marine Protection, Research, and Sanctuaries Act of 1972); Texas Industries, Inc. v. Radcliff Materials, Inc., 451 U.S. 630 (1981) (antitrust laws do not give rise to implied right of contribution).

1, 1982). We find nothing in the legislative history of the ICA that suggests an intent to deprive the company of a direct remedy. Neither, we must concede, do we find an explicit expression by Congress that the investment company is authorized to sue its adviser. But our conclusion is unaffected by this absence of express authorization for, as the Supreme Court noted in canvassing the same legislative history, silence regarding the powers of the board of directors is to be expected: "The ICA does not purport to be the source of authority for managerial power; rather, the Act functions primarily to 'impos[e] *controls and restrictions* on the internal management of investment companies.'" *Burks v. Lasker, supra*, 441 U.S. at 478 (citation omitted) (emphasis in original). Thus we may properly infer from this legislative silence that Congress did not intend to restrict the company's right to sue.

The state of the law at the time of the 1970 amendments supports this construction of the legislative history. We are required to look at this "contemporary legal context" to determine whether the company had a right to sue when the statute was enacted. If such a right existed, we need only determine whether Congress intended to preserve the preexisting remedy. *See Merrill Lynch, Pierce, Fenner & Smith v. Curran, supra*, 102 S. Ct. at 1839. In this regard, we agree with the district court's observation, *see* 516 F. Supp. at 670 n.11, that the company possessed (and still possesses) a cause of action against the adviser at common law.[9] We also note

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9. The common law predecessor to a section 36(b) action was a suit against the adviser for "corporate waste," an action traditionally deemed to be derivative. 13 W. Fletcher, *Cyclopedia of the Law of Private Corporations* ¶¶5924, 5926, 5927 (rev. perm. ed. 1980). Congress found the burden of proving corporate waste "unduly restrictive" and created the fiduciary duties in section 36(b) to reduce the burden of invalidating advisory contracts. S. Rep. No. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901. Because the common law action was derivative, we assume Congress expected the federal action to be derivative as well.

that a shareholder's right to sue *derivatively* was implied by former section 36 (now section 36(a)), which authorizes SEC enforcement of the ICA's regulatory scheme. *See, e.g., Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971) (finding implied right of action under former section 36 for shareholder to sue derivatively to recapture excessive brokerage fees paid by the mutual fund). "Where Congress adopts a new law incorporating sections of a prior law, Congress can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute." *Merrill Lynch, Pierce, Fenner & Smith v. Curran, supra*, 102 S. Ct. at 1841 n.66. Against this legal backdrop at the time of the amendments, Congress' assumption that the shareholder suit was derivative from the company's right of action becomes clear, as does the correctness of the First Circuit's conclusion that Congress assumed the company enjoyed a direct cause of action and there was no need to so specify. In sum, the second *Cort* criterion is met for the reasons set forth by the First Circuit in *Grossman* and because we find no evidence of a Congressional intent to deprive the company of its right to sue the company's adviser.

The third and fourth factors of the *Cort* test follow ineluctably from the preceding discussion. Providing the investment company with a cause of action fully accords with the purposes of section 36(b) by providing another means to recover excessive advisory fees. From a practical standpoint, in fact, the company's financial resources and knowledge of the challenged transactions may render it an even more effective litigant than the shareholder. Finally, the express cause of action conferred by Congress upon shareholders *ipso facto* federalizes this type of litigation; hence implication of a companion remedy for the investment company does not intrude upon an area "traditionally relegated to state law." Thus application of the four-pronged test of *Cort v. Ash* compels us to conclude that the investment com-

pany has a cause of action against the advisers for breach of the fiduciary duties imposed by section 36(b). We are aware that the Court of Appeals for the Second Circuit recently reached the opposite conclusion. *Fox v. Reich & Tang, Inc.*, No. 82-7296 (2d Cir. Oct. 26, 1982). After careful consideration of the court's reasoning, however, we remain convinced that the investment company has a cause of action and that a §36(b) action is derivative.

III. *IS SECTION 36(b) CONSISTENT WITH THE DEMAND REQUIREMENT?*

Even if a section 36(b) suit is derivative, Weiss insists that the ICA excuses such suits from the Rule 23.1 demand requirement. As we have noted, he concedes that the statute does not do so expressly, but contends that the legislative history and statutory scheme of section 36(b) manifest Congress' intent to eliminate this prerequisite to suit.

At the outset we note that Weiss must overcome the presumption that Rule 23.1, like all Federal Rules of Civil Procedure, applies to any civil suit brought in federal district court unless inconsistent with an Act of Congress. Fed. R. Civ. P. 1; *see* 28 U.S.C. §2071 (1976). Abrogation of a rule of procedure generally is inappropriate "[i]n the absence of a direct expression by Congress of its intent to depart from the usual course of trying 'all suits of a civil nature' under the Rules established for that purpose." *Califano v. Yamasaki*, 442 U.S. 683, 700 (1979). Repugnancy of a statute to a civil rule is not to be lightly implied. Rather, "a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible." *Grossman v. Johnson, supra*, 674 F.2d at 122-23 (quoting 7 *Moore's Federal Practice* ¶86.04[4] at 86-22 (2d ed. 1980)); *accord Fox v. Reich & Tang, Inc.*, 94 F.R.D. 94 (S.D.N.Y. 1982), *rev'd on other grounds*, No. 82-7296 (2d Cir. Oct. 26, 1982).

A. *Does the Legislative History Reflect Congress' Intent to Require Demand?*

Weiss relies first on the legislative history accompanying the 1970 amendments, passages of which reflect Congress' perception that even unaffiliated directors had not been able to secure changes in the advisory fee levels. For example, he quotes from the Securities and Exchange Commission Report on Investment Companies, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966):

> It has been the Commission's experience in the administration of the Act that in general *the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates in the mutual fund industry.*
>
> . . .
>
> The analysis of the shareholder fee litigation not only underscores the need for changes in existing statutory provisions relating to management compensation in the investment company industry, but points to the direction which these changes should take. It makes clear the need to incorporate into the Act a clearly expressed and readily enforceable standard that would measure the fairness of compensation paid by investment companies for services furnished by those who occupy a fiduciary relationship to such companies.
>
> . . .
>
> The right of the *Commission as well as investment company shareholders* to take action against violations of the *statutory standard of reasonableness* is essential to effective enforcement.

Id. at 131, 143, 146 (emphasis supplied by appellant). Second, he invokes the Congressional intention to establish a mechanism by which the shareholders and courts

could enforce the investment adviser's fiduciary duty. The report accompanying the 1970 amendments states:

> In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.
>
> Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, *there should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty.*

S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4898 (emphasis supplied by appellant).

These passages do not reflect a "direct expression by Congress" of its intent to eliminate the demand requirement. Expressions that shareholders and the SEC need increased judicial access in order to insure the reasonableness of advisory fees do not denote an intent to bypass the directors completely. On the contrary, the legislative history is replete with references to Congress' intent to preserve, not preempt, the role of management in negotiating advisory fees. The Senate Report emphasizes this point:

> [Section 36(b)] is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees. . . . Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an

investment company in the best interest of its shareholders from the directors of such company to the judiciary.

S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4902-03. The clear intent of Congress was to install management as "the first line of defense for the individual investor" against any self-dealing by the adviser. *Fox v. Reich & Tang, Inc., supra*, 94 F.R.D. at 96. As the Supreme Court noted in *Burks v. Lasker, supra*, 441 U.S. at 484-85, the 1970 amendments were designed to place the unaffiliated directors in a "watchdog" role. Requiring that shareholders make a demand upon the directors is fully consonant with this purpose.

Requiring demand also accords with the legislative history, which itself alludes to the continued operation of the demand requirement. During Congressional hearings on the proposed amendments to the ICA, then SEC Chairman Hamer Budge assured the committee that providing shareholders with a cause of action would not encourage nuisance suits: "As we have pointed out previously, there are adequate safeguards under the Federal Rules of Civil Procedures [sic] and under this bill to prevent unjustified shareholder litigation." *Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. of Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess. 201 (1969); *accord id.* at 860. It is clear to us that this statement refers to Rule 23.1 and its demand requirement. Contrary to Weiss' suggestion, the legislative history reflects an implicit understanding that Rule 23.1 would apply — an understanding which comports with the purposes of section 36(b).

B. *Is the Statutory Scheme Consistent with the Requirement of Shareholder Demand?*

Weiss' final arguments regarding the alleged inapplicability of Rule 23.1 spring from his contention that

the structure of section 36(b) is inconsistent with the requirement of shareholder demand, and that Congress therefore did not contemplate demand as a prerequisite to suit. Weiss makes three arguments. The first two require only brief discussion; the third merits more extensive treatment.

1. *The Effect of the One-Year Limitation on Recovery*

Weiss asserts that demand cannot be required because: (1) section 36(b) limits the recovery of unreasonable fees to those that were paid during the one-year period prior to commencement of suit; (2) once a shareholder plaintiff makes a demand, the directors can delay a response while the excessive fees continue to be paid; and (3) Congress could not have intended to interpose the demand requirement because the time consumed by the directors in responding to demand would time-bar claims to recover fees paid out by the investment fund. At least one court has identified this statutory provision as a basis for suggesting, in dictum, that demand should not be a prerequisite to a section 36(b) suit. *See Blatt v. Dean Witter Reynolds Intercapital, Inc.*, 528 F. Supp. 1152, 1155 (S.D.N.Y. 1982).

We recognize that in some cases, demand will postpone the filing of suit and thereby move forward the one-year period allowed for the recovery of fees. In most instances, however, this will not reduce the allowable recovery. In any event, we do not see why demand cannot be promptly made and expeditiously considered.[10] Notwithstanding Weiss' intimations to the contrary, de-

10. The First Circuit, in rejecting the identical argument, suggested that the district court could allow suit to go forward without waiting for a response if the directors unduly postpone a response to demand. *Grossman v. Johnson, supra*, 674 F.2d at 122. We intimate no view here concerning the propriety of that suggestion.

mand is a simple procedure that is not burdensome to the shareholders. We therefore do not believe that the one-year limitation period compels the conclusion that Congress intended to eliminate the demand requirement.[11]

2. *The Analogy to Section 16(b) of the Securities Exchange Act of 1934*

Weiss advances a somewhat tortured analogy between section 36(b) of the ICA and section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b) (1976), which allows shareholders to recover illegal insider "short swing" profits. Suits brought under section 16(b) are exempt from the contemporaneous ownership requirement of Rule 23.1. *Blau v. Mission Corp.*, 212 F.2d 77, 79 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954). Weiss perceives similarities between insider trading and "insider" advisory fees. He suggests that section 36(b), like section 16(b), is an instrument of public policy which should not be hampered by procedural restrictions such as the demand requirement of Rule 23.1.

Without reaching the merits of the statutory analogy, we simply note that it is irrelevant: suits to recover short swing profits under section 16(b) are subject to the demand requirement by the very terms of that statute, which states that a shareholder may institute an action "if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter." 15 U.S.C. §78p(b) (1976). We therefore join the First Circuit in rejecting this argument as specious. *See Grossman v. Johnson, supra*, 674 F.2d at 120.

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11. Additionally we note that the short statute of limitations may reflect a Congressional view of the ICA as designed to ameliorate the situation prospectively rather than to establish a long damage period.

3. *The Relationship Between Shareholder Demand and the Exercise of the Directors' Business Judgment*

The heart of Weiss' challenge based on the statutory scheme is his assertion that shareholder demand is superfluous because that scheme effectively precludes the Fund's directors from taking action in response to any such demand. The premise of his argument is the Supreme Court's suggestion that the ICA deprives the directors of their authority to exercise their business judgment to terminate a section 36(b) suit. In *Burks v. Lasker, supra*, the Court stated:

> when Congress . . . intended to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b) . . . performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees.

441 U.S. at 484. Although section 36(b) was not directly at issue in *Burks*, the Court's interpretation of that section influenced its holding that other sections of the ICA do *not* deprive directors of their authority to terminate derivative suits under the shield of the business judgment rule. Prudence dictates that we accede to this strong signal from the Court that directors may not terminate suits under section 36(b), notwithstanding our perception that the statement's import is unclear. *See infra* pp. 21-22.

Weiss then argues that if a suit's termination is precluded, it would be inconsistent to require demand as a prerequisite to initiation: if directors are too self-interested to be allowed to cut off shareholder suits in the exercise of their business judgment, they must be presumed to be too self-interested to respond objectively to a shareholder demand. Relying in part upon our observation in *Cramer v. General Telephone and Electronics Corp.*, 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*,

439 U.S. 1129 (1979), that the business judgment rule is "inextricably linked" to the demand requirement. Weiss essentially concludes that the Court's inclination to disregard business judgment in this context makes the demand requirement superfluous and inefficient.

Our opinion in *Lewis v. Curtis*, 671 F.2d 779 (1982), lends some credence to Weiss' position.[12] *Lewis* involved a shareholder complaint alleging that demand would have been futile because the directors had participated in an allegedly self-interested transaction.[13] In evaluating this claim, we stated that the futility of demand turns on the disinterestedness of the directors, not on the nature of the alleged wrongdoing. We also noted that the relevant standard of disinterestedness is the same as that used to determine whether a court should defer to the board's business judgment not to pursue a lawsuit on behalf of the corporation.

> There is no reason why a court, in deciding whether a board is sufficiently interested to excuse demand, should not be informed by the same factors used to determine whether a court should defer to the board's decision not to pursue the action. The board will lack such disinterestedness if plaintiff's allegations, taken as true, would show that, under state law, a court should not defer to the board's decision not to pursue the lawsuit. . . .

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12. *Lewis* was published after the briefs in this appeal were filed.

13. The directors were accused of entering into a wasteful settlement agreement with a shareholder. Pursuant to the agreement the shareholder abandoned his proxy contest in which he was seeking a seat on the corporation's board. The complaint also alleged details of a larger scheme by the directors to retain control of the corporation by, among other things, obtaining long-term employment contracts for several directors and reducing the number of directors on the board.

> Some courts have suggested that directors may not be sufficiently interested in a transaction to excuse demand, yet are interested enough to be unable to assert the protection of the business judgment rule. . . . On the other hand, formulating different standards for the two issues is . . . difficult. . . . [W]e do not think that we should apply different standards of "interestedness" to cases in which plaintiff has made no demand and to those in which a demand has been made and rejected.

Id. at 785-86 (citations omitted). Since (according to Weiss' argument) directors are too self-interested to terminate shareholder suits, the logical extension of *Lewis* would be to say that they are so interested that demand should be excused in this case as a matter of law.

Although Weiss' argument is superficially alluring, we find it ultimately unpersuasive. First, to the extent that it is based on *Burks, see supra* p. 19, the argument rests on rather uncertain footing. Weiss would read *Burks* as standing for the proposition that directors may not terminate shareholder suits because directors are too interested in advisory fee transactions. While this is not an implausible reading of *Burks*, we do not find the Supreme Court's rationale so easy to discern. Section 36(b)(2) accords the advisory fee actions of directors only "such consideration by the Court as is deemed appropriate under the circumstances." *Burks* understandably concluded that Congress intended less judicial deference to directors' actions regarding advisory fees than is ordinarily associated with the business judgment rule. But we are unable to divine from that opinion a per se rule that investment company directors are presumed to be self-interested, and we decline to adopt Weiss' suggested rule on such a speculative basis.

Weiss also reads too much into our statement in *Cramer, supra,* that the demand requirement and the

business judgment rule are "inextricably linked." 582 F.2d at 274. Rather, as the district court noted below, *see* 516 F. Supp. at 670 n.13, the policies underlying each doctrine are distinct.

The demand requirement originated as a judicially-created device that forced shareholders to exhaust intra-corporate remedies before beginning suit. As explained in one of the earliest expositions of the principle:

> [I]t is . . . important that before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part.

Hawes v. Oakland, 104 U.S. 450, 460-61 (1882).[14] The requirement reflects judicial cognizance of the prerogatives and expertise of the directors as stewards of the corporate welfare. One commentator summarized this purpose as follows:

> Forcing shareholders to exhaust intracorporate remedies by first making demand on directors allows the directors a chance to occupy their usual status as managers of the corporation's affairs, giving the corporation an opportunity to take control of a suit that will be brought on its behalf. The demand requirement thus furthers a principle basic to cor-

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14. The Court's holding in *Hawes* was adopted in 1882 as Equity Rule 94, and was modified in 1912 by Equity Rule 27 to allow allegations of the futility of demand. Equity Rule 27 became Federal Rule of Civil Procedure 23(b) which, in turn, was promulgated as Rule 23.1 in 1966.

> porate organization, that the management of the corporation be entrusted to its board of directors.

Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171 (1976). When faced with a demand by a shareholder, the directors have a number of options. They can exercise their discretion to accept the demand and prosecute the action, to resolve the grievance internally without resort to litigation, or to refuse the demand. It is at this point that the business judgment rule comes into play.

The business judgment rule eludes precise categorization, as it assumes different shapes in different settings. *See* Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside*, 60 Wash. U.L.Q. 311 (1982). In its traditional form, the rule protects directors from personal liability for business decisions by presuming that they acted in good faith and with reasonable care. *See Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980) (even in a facially self-dealing transaction, the rule assumes directors were "exercising their sound business judgment rather than responding to any personal motivations"), *cert. denied*, 450 U.S. 999 (1981). In shielding directors from the hazards of hindsight challenges to the wisdom of particular decisions, the rule serves two important functions.

> Were courts, with perfect retrospective vision, to second-guess the judgment of officers and directors in their decisionmaking function, they would be injecting themselves into a management role for which they were neither trained nor competent. Such judicial action would also be taking a step to discourage others from performing these desired and essential societal activities. One pragmatic objective of the business judgment rule, then, is to

> keep courts out of a role they are ill-equipped to perform. Another is to encourage others to assume entrepreneurial and risk-taking activities by protecting them against personal liability when they have performed in good faith and with due care, however unfortunate the consequence. Both are of monumental social utility.

Duesenberg, *supra*, 60 Wash. U.L.Q. at 314 (footnotes omitted).

Because the considerations involved in imposing the demand requirement and invoking the business judgment rule are distinct, their applicability is not necessarily coincidental. In fact, this Court so noted in *Cramer*: "[W]hile the demand requirement of Rule 23.1 should be rigorously enforced, we do not think that the business judgment of the directors should be totally insulated from judicial review."[15] The American Law Institute recently expressed a similar view in its proposed Restatement on Principles of Corporate Governance and Structure §7.02, at 270-71 (Tent. Draft No. 1, 1982):

> It is not inconsistent for a court to employ a strict standard with respect to the excusal of demand, but then to refuse to accept a decision by the same board of directors to seek termination of the same action. . . . As some decisions have emphasized, the focus at the demand stage should be on the issue of whether the corporation may take over the suit and either prosecute it or adopt other internal corrective measures, and not on the later question of whether a decision not to sue should be respected

15. At issue in *Cramer* was whether a determination by a disinterested committee of directors that a litigation was not in the best interests of the corporation barred a shareholder suit alleging violations in connection with GTE's foreign payments. The plaintiff had not made a rule 23.1 demand, however, and we affirmed dismissal of the suit on that ground.

> by the court. At the demand stage, the possibility should not be foreclosed that a demand will induce the board to consider issues and crystallize policies which otherwise might not be given attention (e.g., new accounting controls, revised corporate policy statements or even a change in personnel or remuneration). The demand rule can have efficacy even where the board ultimately rejects the action and the court ultimately permits the plaintiff to sue.

In particular, as we noted in *Cramer*, the demand requirement gives management the opportunity to pursue alternative remedies and to avoid unnecessary litigation. 582 F.2d at 275.

We find the distinction particularly important here in light of Congress' clear intent to enhance the independence of directors and their responsibility for advisory fees. The ICA and its amendments were designed to erase potential conflicts of interest inherent in the structure of investment companies by placing the unaffiliated directors in a substantial management role and providing them with authority to act as checks on advisory fees. Congress explicitly empowered the directors to redress challenges to advisory fees by imposing on directors a duty to evaluate the advisory fees and by authorizing them to terminate investment adviser contracts without penalty upon the giving of sixty days notice. 15 U.S.C. §80a-15(a)(3) (1976).[16] To allow shareholders to bypass the directors would undermine the role shaped for directors by the ICA. The opportunity to resolve the

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16. As appellees note, the directors can respond to a timely shareholder demand by (1) negotiating a rebate of fees, (2) satisfying the shareholder that the fees are reasonable in terms of the investment services provided, (3) persuading the shareholder that litigation would adversely affect shareholders' interests, (4) accepting the demand and instituting suit, or (5) refusing the demand.

shareholder grievance without resort to litigation may, in fact, be especially important if the directors are not able to terminate the suit. In that event the Rule 23.1 demand provides the only opportunity for the Fund to avert a lawsuit through internal corrective measures.[17]

Finally, the different purposes served by the business judgment rule and the demand requirement show that the wooden transposition of *Lewis* to this statutory context is inappropriate. *Lewis* was concerned with the futility of demand. It involved an inquiry which is "intensely factual" and requires particularized pleading by the plaintiff. *See Vernars v. Young*, 539 F.2d 966, 968 (3d Cir. 1976). In a conventional shareholder suit, the evaluation of the directors' decision to refuse demand or terminate suit is equally factual, and it makes sense, as we stated in *Lewis*, to employ the same standard of interestedness. However, a statutory presumption of interestedness cannot substitute for the factual inquiry needed to determine whether a demand on directors "would be likely to prod them to correct a wrong." *Lewis*, *supra*, 671 F.2d at 785.[18]

In sum, to read the ICA's statutory scheme as depriving directors of the opportunity to respond to a shareholder grievance would undermine the very pur-

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17. Weiss' argument is also undermined by reference to §16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b) (1976) which he invoked in another context. *See supra* pp. 18-19. In a §16(b) action, where there is no power by the corporation to terminate, *see* Burks v. Lasker, *supra*, 441 U.S. at 484, n.13; *Cramer*, 582 F.2d at 276 n.22, there is an express demand requirement.

18. Relying in part on *Lewis*, the Second Circuit suggested in *Fox v. Reich & Tang*, *supra*, that the demand requirement would serve no function in the §36(b) context. "[I]t is possible to infer that Congress ... believed directors would always be so 'interested' that demand would inevitably be 'excused.'" *Id.*, slip op. at n.13. Having already explained our conclusion to the contrary, we simply note the tentative nature of the Second Circuit's language.

pose of the ICA — to strengthen management of the Fund by its independent directors. We attribute no such inconsistent intent to the Congress and conclude that the demand requirement of Rule 23.1 applies to section 36(b) actions.[19]

IV. *THE ALLEGED FUTILITY OF DEMAND*

Weiss contends that even if his section 36(b) claim is subject to the Rule 23.1 demand requirement, such demand would have been futile for all counts of his complaint. The complaint alleges that demand is unnecessary because (1) Shearson and the Adviser control and dominate the Fund and its directors; (2) all of the Fund's directors have participated or acquiesced in the Adviser's breach of fiduciary duty; and (3) the hostility of the directors to the claim was evidenced by the filing of an answer to the initial complaint. Amended Complaint at ¶37.

The district court found that the allegations of the Adviser's and Shearson's control over the directors were inadequate to excuse demand: Weiss failed to provide proof sufficient to overcome the fact that four of the six directors who approved the transaction were not "interested" under the terms of the ICA, 15 U.S.C. §80a-2(a)(19) (1976). The district court also rejected Weiss' effort to use the company's answer to the complaint as evidence of the directors' hostility to suit. Applying the edict of this Court that futility "must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight," *see Cramer v. General Telephone & Electronics Corp., supra*, 582 F.2d at 276, the district court concluded that opposition expressed after suit was filed could not excuse demand.

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19. As noted above, *see supra* p. 14, we must presume that the federal rules apply to this action unless expressly displaced by Congress.

Finally, the court turned to the allegation that the directors' participation in the transaction made demand unnecessary. The court first noted that simply naming the directors as defendants cannot automatically excuse demand on the theory that they would have to decide whether to sue themselves.[20] The court then applied the test enunciated in *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973), which states that mere approval of the challenged transaction is insufficient to demonstrate futility of demand unless the complaint alleges facts showing that the transaction was motivated by self-interest or bias. The Court found that Weiss' complaint failed to allege that the directors stood to gain any personal advantage from approval of the advisory contracts; rather, it challenged the directors' action only as a breach of their statutory and common law fiduciary duties. The court accordingly ruled that the pleadings failed to assert a basis for excusing demand.[21] We agree with the analysis of the district court that these allegations are insufficient to excuse demand and affirm on that basis.

V. *DENIAL OF WEISS' MOTION TO REPLEAD AFTER MAKING DEMAND*

Finally, Weiss contends that the district court abused its discretion in refusing him leave to replead after a demand on the Fund's directors. He relies principally on *Markowitz v. Brody*, 90 F.R.D. 542 (S.D.N.Y.

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20. This conclusion was cited with approval in our decision in Lewis v. Curtis, *supra*, 671 F.2d at 785.

21. *Lewis v. Curtis*, *supra*, which was decided after the district court's decision below, does not mandate a different conclusion. As did *Kauffman*, *Lewis* held that the futility of demand turns on the interestedness of the directors rather than the nature of the wrongdoing. *See supra* pp. 20-21. Unlike this case, however, *Lewis* involved specific allegations of a self-interested transaction by all the directors. *See* 671 F.2d at 787.

1981), in which the court stayed dismissal for ninety days in order to allow plaintiff the opportunity to make a demand.

We reject this contention as well. The law of this circuit makes clear that demand after a complaint has been filed is impermissible since it would "reduce the demand requirement of the rule to a meaningless formality." *Schlensky v. Dorsey*, 574 F.2d 131 (3d Cir. 1978). We recognize that application of this rule in this context may seem costly given the Act's limitation on recovery to the excessive fees received during the year immediately prior to the filing of suit. Nevertheless, requiring demand before the filing of suit affords directors "the opportunity to decide in the first instance whether and in what manner action should be taken." *Id.* A demand after suit is filed would usurp this prerogative.

The district court's judgment dismissing the complaint will be affirmed.

GIBBONS, *Circuit Judge*, dissenting.

This is an appeal from a judgment dismissing a multi-count complaint by a shareholder of a money market fund for failure to comply with the demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure.[1] I agree with the majority that the district court properly dismissed all causes of action pleaded in the complaint except that based upon section 36(b) of the Investment Company Act of 1940[2] (ICA). As to that claim I would reverse.

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1. The district court's opinion is reported. Weiss v. Temporary Investment Fund, Inc., 516 F. Supp. 665 (D. Del. 1981). Plaintiff also appeals from the court's denial of his subsequent motion for leave to comply with Rule 23.1 and to file an amended complaint. 520 F. Supp. 1098 (D. Del. 1981).

2. 15 U.S.C. §80a-35(b) (1976).

I.

Plaintiff Melvyn I. Weiss, custodian for his son, Gary M. Weiss, is a shareholder of the Temporary Investment Fund, Inc. (Fund), a no-load, open end, diversified investment company, or "money market fund." In 1980, Weiss brought a shareholder's derivative suit against the Fund, the Provident Institutional Management Corp. (Provident), which acts as the Fund's investment adviser, Shearson Loeb Rhoades, Inc. (Shearson), the Fund's underwriter which also performs administrative duties for the Fund, and seven directors of the Fund. Weiss alleges that Provident and Shearson breached their fiduciary duties under section 36(b) of the ICA by receiving excessive and unreasonable compensation for management services. Weiss further alleges that the various defendants participated in or acquiesced in various breaches of fiduciary obligations owed the Fund and in violations of the Securities Exchange Act of 1934,[3] the Banking Act of 1933,[4] the ICA[5] and the common law. The complaint acknowledges that no demand was made on the directors of the Fund to bring a similar action but alleges that such a demand would be futile. The district court, however, concluded that the plaintiff's failure to make such a demand pursuant to Rule 23.1 was fatal to the action, and dismissed it.[6] Subsequently, Weiss filed a motion for reargument requesting that the court grant him leave to file an

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3. Specifically Section 14(a), 15 U.S.C. §78n (a) (1976), and Rule 14a-9, 17 C.F.R. §240 (1977), adopted thereunder.

4. Specifically Sections 16 and 21, 12 U.S.C. §§24 & 378(a) (1976).

5. Specifically Sections 20(a), 1(b)(2), 15(a) and 15(b), 15 U.S.C. §§80(a)-1-80a-52.

6. The court also dismissed the complaint as to defendant Robertson for insufficient service of process on him. Plaintiff does not challenge that ruling on appeal, so we leave the court's judgment in that respect undisturbed.

amended complaint after making a demand on the directors. He also asked the court to reconsider its determination of non-compliance with Rule 23.1. The district court refused to reconsider, or to grant leave to make a demand.

II.

Rule 23.1 of the Federal Rules of Civil Procedure specifies several pleading requirements "[i]n a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it . . ." Fed. R. Civ. P. 23.1. Among those requirements is that of pleading that a demand has been made on the directors to enforce a right which the corporation may properly assert.[7] Rule 23.1 finds its genesis in Equity Rule 94, 104 U.S. IX (Jan. 23, 1882), which adopted as an Equity Rule the Supreme Court's holding in *Hawes v. Oakland*, 104 U.S. 450 (1881).[8] The Court in *Haws* stated that

7. The demand requirement of Rule 23.1 reads:

> The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort.

Fed. R. Civ. P. 23.1.

8. Rule 23.1 was promulgated in 1966. It substantially restated prior Rule 23(b) adopted in 1937 which in turn was a transcription of Equity Rule 27. Equity Rule 27, established in 1912, was itself a slight modification of Equity Rule 94 adopted in 1882. The demand requirement of Equity Rule 94 read:

> [the complaint] must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors or trustees, and, if necessary, of the shareholders, and the causes of his failure to obtain such action.

104 U.S. at X.

> before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court.

104 U.S. at 460-61. This judicially-created demand requirement has survived with slight modification in Rule 23.1. *Hawes* was decided, and Equity Rule 94 was promulgated, during the regime of *Swift v. Tyson*, 41 U.S. (1 Pet.) 1 (1842), when federal courts were free to establish their own equitable remedial jurisprudence. *See* Judiciary Act of 1789, ch. 20, §11, 1 Stat. 926; Process Act of May 8, 1792, ch. 36, §2, 1 Stat. 276 (1850). There was, therefore, no need to decide whether Equity Rule 94, with its demand requirement, was substantive law or merely a procedural provision.

Two developments changed that indifference. One was the 1938 merger of law and equity. The other was the Supreme Court's decision in *Guaranty Trust Co. v. York*, 326 U.S. 99 (1945), applying the *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), choice of law to prevent the application of a federal equitable remedial rule in a diversity case. In light of that holding, the procedural or substantive character of the demand requirement of Rule 23.1 becomes important.

It is clear that Congress did not deal with the *Erie* choice of law question with respect to Rule 23.1. The Federal Rules of Civil Procedure were promulgated by the Supreme Court on December 20, 1937 and reported to Congress on January 3, 1938. *Erie v. Tompkins* was argued to the Court on January 31, 1938, and was decid-

ed in April 1938. Congress adjourned on June 16, 1938 and the Rules took effect September 16, 1938. That chronology of events makes it highly unlikely that Congress examined the remedial versus procedural aspects of the demand clause in Rule 23.1. The origins of Rule 23.1 are of little help, since, as indicated above, the question in 1882 of whether Rule 23.1 was procedural or substantive need not have been asked. We are left, therefore, with the task of construing a Federal Rule of Civil Procedure in such a manner as to ensure its validity in actions involving state law claims. *See, e.g., Hanna v. Plumer*, 380 U.S. 460 (1965).

This court has held that a plaintiff-shareholder's obligation to make a demand on the corporate directors before pursuing a derivative claim is inextricably linked to the state law business judgment rule. *Cramer v. GTE Corp.*, 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979). "Once the shareholder has made a demand upon the directors, the directors are then able to determine whether in their opinion a suit on behalf of the corporation would comport with the best interests of the corporation." *Id.* at 275. The directors can pursue remedies alternative to litigation, can terminate meritless causes of action, and can determine whether litigation cost and other adverse effects on business relationships with potential defendants would outweigh any potential recovery from the lawsuit. The directors' decision to allow suit or not is insulated from judicial review by the business judgment rule. The rule is a substantive one, intended to enforce the elected management's responsibility for operating the corporation, while insulating it from liability for good faith mistakes made while performing its duties. *See Briggs v. Spaulding*, 141 U.S. 132, 146-148 (1891).

Subsequent to our decision in *Cramer v. GTE Corp.*, 582 F.2d 259, the Supreme Court had occasion to make explicit what was implicit in the *Cramer* discussion: that

the substantive business judgment rule is a rule of state, not federal law. In *Burks v. Lasker*, 441 U.S. 471 (1979), the Court considered whether state or federal law governs the power of a corporation's directors to terminate a derivative suit, and ruled:

> We hold today that federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the [federal statutes relied upon].

Id. at 486.

It is clear, then, that the business judgment rule which Rule 23.1 enforces is not a product of federal substantive law. If the rule is to be considered valid under *Erie*, it must now be regarded as the procedural means whereby federal courts ensure that the underlying substantive state law business judgment rule is implemented. The Rule 23.1 demand requirement is, therefore, a procedural device that since *Erie* is animated by the existence of an underlying substantive content. As a necessary corollary, if it is determined that for a given cause of action the directors do not have the substantive power under the relevant law to prevent or to terminate the derivative action, then the demand requirement of Rule 23.1 is not activated since its application would serve no meaningful purpose. *A fortiori*, if the cause of action is one which the corporation could not bring on its own behalf, Rule 23.1 cannot apply. This is plain from the text of the rule, and would be required as a matter of choice of law in any event.

The issue, thus, is the choice of law to be made in determining whether the underlying cause of action admits to the application of a state law business judgment rule which a Rule 23.1 demand would effectuate. In diversity cases or for pendent state law claims, the relevant substantive law is constitutionally mandated to be state law and, hence, a Rule 23.1 demand requirement is al-

ways triggered by the state business judgment rule. In non-diversity cases, *Erie* is of no relevance with respect to the elements of the cause of action. Yet as the Supreme Court makes clear in *Burks v. Lasker*, 441 U.S. 471, federal courts ordinarily look to state corporate law for the existence of an applicable business judgment rule. The federal courts' adoption of state corporate law when deciding the scope of the corporate directors' powers to terminate or to prevent derivative suits is merely a rule of statutory construction. It is based on a judicial determination that Congress in creating federal causes of action does so against a background of state corporate law to which federal courts must refer even though the cause of action is based on federal law. *See Burks v. Lasker*, 441 U.S. at 478-79. *See also Johnson v. Railway Express Agency*, 421 U.S. 454, 465 (1975). That general proposition is qualified, however, by the requirement that the state may not contravene the policies of the federal law with respect to which the business judgment question arises. *See, e.g., Burks v. Lasker*, 441 U.S. at 478-79. The demand requirement under Rule 23.1 is applicable even to federal causes of action because the state law business judgment rule applies unless the relevant federal law preempts exercise of business judgment. A demand is required only if the corporation may assert the cause of action relied upon, and the substantive law giving rise to the cause of action permits the directors to terminate it in the exercise of their business judgment.

III.

For all causes of action asserted by Weiss except that under section 36(b) of the ICA, a demand is required because they depend on state law, or on non-preemptive federal law, and the directors may exercise business judgment to take over or to terminate the claim. Of course, the business judgment rule is inapplicable, as a matter of state law, where the directors' judg-

ment is not in good faith, is the product of self-dealing or is made under the influence of persons suspected of wrongdoing. Moreover, the directors' discretion is not unbounded, and courts may examine their action to determine whether it is within the permissible bounds of that discretion.

Weiss urges that for all counts a demand on the Fund directors should be excused as futile. Like the majority, I am unconvinced. We previously stated that:

> The Supreme Court and, following it, the Courts of Appeals have repeatedly stated and applied the doctrine that a stockholder's derivative action, whether involving corporate refusal to bring anti-trust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way.

Landy v. FDIC, 486 F.2d 139, 149 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), *quoting Ash v. International Business Machines, Inc.*, 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966). Weiss' allegations do not, however, state with particularity reasons why the directors would not be able properly to make the choice whether to sue. "Instead of being 'a statement of appropriate and convincing facts' that a demand would have been futile, [plaintiff's allegations constitute] merely a vague, conclusory statement." *Landy v. Federal Deposit Insurance Corporation*, 486 F.2d at 148 (citation omitted). Thus I agree that the District Court did not err in dismissing those state law and federal law claims as to which the state law business judgment rule clearly applies.

IV.

Whether Rule 23.1 applies to a claim asserted under section 36(b) of the ICA depends on (1) whether such a claim is one belonging to the corporation, and (2) if it is, whether it is one as to which the state law business judgment rule may as a matter of federal substantive law apply. Section 36(b) is part of a group of amendments, enacted in 1970, to the Investment Company Act of 1940. Congress decided that mutual funds deserved special regulation because:

> Mutual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, that are separately owned and operated. These separate organizations are usually called investment advisers. The advisers select the funds' investments and operate their businesses. For these services they receive management or advisory fees.
>
> . . .
>
> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

S. Rep. No. 184, 91st Cong., 2d Sess. 5, *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901.

The primary method by which Congress sought to control the peculiar problems of mutual funds was the

requirement that at least 40% of fund directors be independent. These "unaffiliated" directors are given the main burden of supervising the management and the finances of the fund. *See Burks v. Lasker*, 441 U.S. at 482-83. In certain areas of the funds' dealings, however, Congress did not leave matters to final resolution by the unaffiliated directors. Rather, it mandated alternative forms of regulation. One area of special concern is the compensation paid by a mutual fund to its adviser. The Senate Report vividly points up that concern:

> In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.
>
> Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means *for the courts to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty*. This bill would make it clear that, as a matter of Federal law, the investment adviser or mutual fund management company has a fiduciary duty with respect to mutual fund shareholders. It provides an effective method whereby *the courts can determine* whether there has been a breach of this duty by the adviser or by certain other persons with respect to their compensation from the fund.

S. Rep. No. 184, 91st Cong., 2d Sess. 2, *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4898 (emphasis added). Referring to what is now section 36(b), the Senate Report observes:

> This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of man-

agement fees. It does, however, authorize *the court to determine* whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee.

* * *

Directors of the fund, including the independent directors, have an important role in the management fee area. A responsible determination regarding the management fee by the directors including a majority of disinterested directors is not to be ignored. While *the ultimate responsibility for the decision in determining whether the fiduciary duty has been breached rests with the court*, approval of the management fee by the directors and shareholder ratification is to be given such weight as the court deems appropriate in the circumstances of a particular case.

* * *

Under this proposed legislation either the SEC or a shareholder may sue in court on a complaint that a mutual fund's management fees involve a breach of fiduciary duty.

Id. at 4902-03 (emphasis added). This report plainly discloses that while the court must afford deference to the views of fund directors, the ultimate resonsibility for deciding whether the fees are so high as to be regarded as a breach of fiduciary duty is judicial. Nowhere in the legislative history of section 36 is there any suggestion that fund directors — even unaffiliated directors — can seek such a judicial determination. Only the SEC and shareholders are indicated. With that illuminating legislative history in mind we turn to the statute as enacted.

Prior to 1970, section 36 of the ICA authorized the SEC to seek an injunction barring persons in a fiduciary relationship to a fund from acting in such capacity if they were in the five years prior to the action guilty of "gross misconduct or gross abuse of trust." Investment

Companies Act of 1940, Pub. L. No. 76-768, §36, 54 Stat. 841 (1940). No other relief was authorized. In 1970 section 36 was amended to eliminate the "gross misconduct or gross abuse of trust" standard so as to authorize an SEC suit if the fiduciary "has engaged . . . or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company. . . ." 15 U.S.C. §80a-35(a) (1976). The relief available in an SEC suit was also enlarged so as to permit not only orders barring future participation as a fiduciary, but also "such injunctive or other relief against such person as may be reasonable in the circumstances. . . ."

At the same time an entirely new remedy, dealing specifically with adviser compensation, was added in a new subsection 36(b).[9] It authorizes an action "by the

9. Section 36(b) reads:

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing

Commission, or by a security holder of such registered investment company, against such investment adviser, . . . for breach of a fiduciary duty in respect of . . . compensation. . . ." 15 U.S.C. §80a-35(b) (1976).

There are several significant features to the 1970 amendment to section 36. In the 1940 Act, the Section dealt only with SEC enforcement, and the sole remedy was to bar the offender from the investment company industry. Section 36 created no cause of action, express or implied, in favor of a fund. The 1970 amendments both carried forward and broadened the SEC enforcement powers in section 36(a). Plainly the "other relief" available under that section would include an accounting which would inure to the benefit of a defrauded fund — not to the SEC. Yet there is no suggestion that the fund could plead a cause of action for the same relief which would be available under section 36(a) in an action by the SEC. As Judge Tyler observed:

> section 36(a) of the Investment Company Act, 15 U.S.C. §80a-35(a), authorizes the SEC to bring ac-

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NOTE (Continued)

for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

tions against certain individuals or companies for breaches of fiduciary duty involving personal misconduct. Section 36(a), however, authorizes an action by the SEC, not by private individuals. Although this should not be read to prohibit suits by individuals when other sections of the Investment Company Act are violated, when only a general breach of fiduciary duty is alleged, a private suit should more properly be brought in state court.

Monheit v. Carter, 376 F. Supp. 334, 342 (S.D.N.Y. 1974). A section 36(a) action by the SEC may be considered "derivative" in the sense that it may right a wrong committed against a fund, and may even obtain relief in favor of a fund, but it certainly is not "derivative" in the sense that the section 36(a) cause of action belongs to the fund in the first instance. It is only to such a cause of action that Rule 23.1 has any application.

Turning to the new cause of action created in section 36(b) with respect to adviser compensation, we cannot, in determining legislative intention, overlook the significant fact that Congress chose to house it not in a separate provision, but as an amendment to a section which from the beginning dealt with public rather than

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(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

15 U.S.C. §80a-35(b) (1976).

private enforcement. While Subsection 36(b) does not say in as many words "a state law business judgment rule cannot terminate an action under this section," permitting the directors of a fund to exercise business judgment in order to prevent an SEC action would be inconsistent with the provision that

> [i]n any such action approval by the board of directors of such investment company of such compensation or payments . . . and ratification or approval of such compensation or payments . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances.

15 U.S.C. §80a-35(b)(2) (1976). Whereas under the typical state law business judgment rule the disinterested directors' decision exercised in good faith binds the court, under section 36(b) the court must make an independent judgment. Moreover, no distinction is made, in this respect, between an action brought by the SEC and one brought by a shareholder. It seems to me, therefore, that by creating the SEC cause of action and the shareholder action in the same sentence, and housing both in a section of the ICA which historically dealt with public rather than private enforcement, Congress disclosed a rather clear intention that the stockholder action be a variety of private attorney general action, *i.e.*, outside the control of the fund's directors. That intention is strongly confirmed by the excerpts from the Senate Report quoted above. It is confirmed, moreover, by the absence of any provision in section 36(a) or (b) for a cause of action by the fund itself.

The majority concludes, despite the absence of any provision in section 36 for a suit by the fund, that the cause of action does belong to the fund, and thus falls within the terms of Rule 23.1. To affirm, the majority must make this assertion, for if the security holders' cause of action is not one which the fund could assert, it

is not derivative, at least not in the sense of Rule 23.1. The majority, however, points to no legislative history suggesting that the fund can bring a Section 36(b) suit. I do not believe the omission of a provision for suits by the fund itself was inadvertent. If the fund were authorized to sue, a litigated or, more significantly, a consent judgment would raise serious questions of the preclusive effect of the judgment on any subsequent action by the SEC or a shareholder.[10] The most likely interpretation is that Congress intended to create a cause of action solely by the SEC, or by a shareholder acting in a private attorney general capacity, so as to preclude consent judgments entered into by the fund and which might have the effect of precluding the judicial review of director judgment mandated by 15 U.S.C. §80a-35(b)(2). Such an intention is suggested by legislative history indicating that one of the reasons for expressly allowing suit to be brought by either the SEC or a security holder was the congressional assessment that the fund directors could not effectively deal with adviser compensation. The Senate Report stated that the 1970 amendments to the ICA were predicated on the SEC's 1966 report and recommendations on investment companies. "Public Policy Implication of Investment Company Growth," Report of the Committee on Interstate and Foreign Commerce, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966). In that report, the SEC indicated its judgment that:

> The unaffiliated directors, as the only potentially disinterested persons in the management of most investment companies, can and should play an active role in representing the interests of shareholders not only in connection with management compensation but in other areas where the interests of

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10. *See* 13 Fletcher Cyc. Corp. §6043 (Permanent Ed.) and cases cited therein.

the professional managers may not coincide with those of the company and its public investors. Strengthening the voice of truly disinterested directors in investment company affairs is important to the protection of public shareholders. *But even a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company's adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation.*

The unaffiliated directors are not in a position to bargain on an equal footing with the adviser on matters of such crucial importance to it. They are not free, as a practical matter, to terminate established management relationships when differences arise over the advisory fees or other compensation. This reflects, in large part, the adviser-underwriter permeation of investment company activities to an extent that makes rupture of the existing relationships a difficult and complex step for most companies. *For these reasons, arm's-length bargaining between the unaffiliated directors and the managers on these matters is a wholly unrealistic alternative.*

Id. at 148 (emphasis supplied). It seems unlikely that Congress intended that the unaffiliated directors, by bringing and settling a section 36(b) suit, could accomplish the very result that the SEC regarded as an unrealistic alternative. Thus I do not believe that section 36(b) grants "a right which may properly be asserted by [the fund]." Fed. R. Civ. P. 23.1.

Even if, contrary to its plain language and probable purpose, section 36(b) were to be construed as creating "a right which may properly be asserted by [the fund]," *id.*, there would still remain the question whether the disinterested directors of the fund may, in the exercise of business judgment, prevent a judicial examination, sought by the SEC or a security holder, of advisers fees.

Other aspects of the section support a negative answer. There is a one year period of limitation. 15 U.S.C. §80a-35(b)(3). Such a short period suggests that intervention by fund directors was not contemplated, for if a claim were to be delayed until the directors were notified and were given a chance to consider the advisability of a given action, the statutory period would quickly run out. By adjusting fees prospectively, while delaying the decision on whether to sue for fees already paid, fund managers could significantly reduce recovery. The normal delays incident to corporate decision-making are incompatible with a one year period of limitation, and director involvement therefore must have been discounted by Congress. Another aspect suggesting the inapplicability of the business judgment rule to section 36(b) is the circumscribed nature of a 36(b) cause of action. Recovery is limited to actual damages capped by the total compensation paid. Recovery can only be had from the recipients of compensation, and liability cannot be the predicate for an injunction severing an investment adviser from a fund. These limitations on the section 36(b) remedy minimize the intrusion by the Section upon the directors' responsibility to operate the fund, and suggest the absence of any serious erosion of the management responsibility conferred by state law.

I conclude, therefore, that the Rule 23.1 demand requirement does not apply to a section 36(b) action, because the Section does not provide "a right which may properly be asserted by [the fund]", and because even assuming such a right, section 36(b)(2) preempts any state law business judgment rule which would be furthered by the demand requirement.

This interpretation of section 36(b) has been anticipated by the Supreme Court. In *Burks v. Lasker*, 441 U.S. at 484, the Court stated that:

> [w]hen Congress . . . intend[ed] to prevent board action from cutting off derivative suits, it said

> so expressly. Section 36(b), . . ., 15 U.S.C. §80a-35 (b)(2), added to the [Investment Company] Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees.

The holding in *Burks v. Lasker* that the state law business judgment rule permits independent directors to terminate derivative suits based on federal statutes so long as the rule is consistent with the policies of the federal statutes in issue, puts the quoted statement in context. The application of business judgment to terminate a section 36(b) suit is inconsistent with the policy of that section. The majority treats the statement of the *Burks* Court as a mere *dictum* which this court can disregard. If it is *dictum*, it is *dictum* of the most compelling sort. The quoted passage was not a passing reference, but was integrally tied to the Court's holding and reasoning. The Court supported its position about fund directors' power to terminate other derivative actions by pointing to section 36(b) as an example of Congress, in clear terms, preventing director veto. The *Burks* reasoning depends, therefore, on the quoted *dictum* with respect to section 36(b) and it cannot be disregarded by this intermediate court.

The Court of Appeals for the Second Circuit, which in matters relating to the federal securities law carries particular authority, confronted with the identical problem, reached the same conclusion with respect to section 36(b) as I reach. Moreover it concluded, as I do, that Rule 23.1 is inapplicable because, as *Burks v. Lasker* teaches, it is designed to implement the business judgment rule only in cases where directors can control a lawsuit. *Fox v. Reich & Tang, Inc. and Daily Income Fund, Inc.*, No. 82-7296, slip op. (2d Cir. Oct. 26, 1982).

Despite the unambiguous statement in *Burks v. Lasker* that section 36(b) is an instance in which Congress has precluded the application of any state law busi-

ness judgment rule, the Court of Appeals for the First Circuit recently affirmed the dismissal of a section 36(b) action for failure to plead compliance with the demand requirement of Rule 23.1. *Grossman v. Johnson*, 674 F.2d 115 (1st Cir. 1982). With deference, I am not persuaded by that court's interpretation of the statute, its treatment of the legislative history, or its reading of *Burks v. Lasker*. Thus while the *Grossman v. Johnson* opinion supports the defendants, I would not follow it. I find particularly unpersuasive the *Grossman* court's treatment of 15 U.S.C. §80a 35(b)(2) (1976). While acknowledging that the section "can easily be read to give the court, rather than the directors, the ultimate power to decide the propriety of the fees," it reasoned that a demand would not be futile, because the directors' "decision to side with the complainant (entirely or in part) would have important consequences, and even their knowledgable disagreement with the demand might be deemed worthy by the court of grave consideration under §36(b)(2)." 674 F.2d at 121. Section 36(b)(2) explicitly directs the court to give the directors' views "such consideration . . . as is deemed appropriate under all the circumstances." 15 U.S.C. §80a 356(b)(2) (1976). Obviously those views can be made known during the course of the lawsuit. But the court's obligation to take the directors' views into account does not, even under the *Grossman* court's analysis permit the directors to terminate or to prohibit the security holders' action. Thus the demand which that court required served no purpose but to delay judicial inquiry and to insulate more payments to the investment adviser from such judicial review by operation of the short statute of limitations in section 36(b)(3). Since the directors' business judgment is to be considered relevant to a section 36(b) claim only to the limited extent that the court must take the directors' views into account, any state law business judgment rule is clearly supplanted. What must be reconciled is section 36(b)(2) and Rule 23.1. No federal policy

suggests itself which would support a mechanistic application of the demand requirement when the only purpose to be served is to give the directors an opportunity to make their views known to the court. That can be done in an appropriate pleading.

The majority's analysis, relying on *Cort v. Ash*, 422 U.S. 66 (1975), is as flawed as that of the *Grossman* court. It must be noted that the *Cort v. Ash* test for implying causes of action in favor of parties not mentioned in a federal statute has been significantly contradicted by subsequent cases such as *Texas Industries, Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 639 (1981), and *Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n*, 453 U.S. 1, 13 (1981). We must look for a clear indication of congressional intent to afford such a cause of action. Neither the statutory language nor its legislative history contains any such indication of an intent to permit an investment fund to control a section 36(b) claim and thereby insulate it from judicial review. Indeed, as I have outlined above, a contrary intent is the most likely.

Finally, the majority's reliance on *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 102 S. Ct. 1825 (1982), is an extreme misinterpretation of that authority. The *Curran* case found a congressional intention, when amending the Commodity Exchange Act by the Commodity Futures Trading Act of 1974, to recognize that prior to the amendment lower federal courts had implied causes of action from the former although it did not expressly provide for them. No cause of action had been implied for the entirely new cause of action created in section 36(b) because that cause of action did not exist at the time Congress last spoke. The suggestion that the *Curran* analysis applies because a fund could bring a common law action against an adviser for corporate waste demonstrates confusion about the nature of the problem which the *Curran* Court addressed. Common law causes of action are not "implied" from federal stat-

utes. They exist as a matter of state law. Moreover, the suggestion ignores the clear intention, in section 36(b), to create a right to recover overcharges which could not be recovered under the state common law of waste.

V.

Since the governing federal law does not permit direct control over section 36(b) actions, it supplants the applicable state law business judgment rule. No section 36(b) policy would be advanced by applying the demand requirement of Rule 23.1 to section 36(b) actions. Absent an underlying substantive rule of law which the pleading requirements of Rule 23.1 would advance, their application serves no useful purpose. The trial court erred, therefore, in dismissing the complaint for failure to plead that a demand had been made on the directors. The judgment appealed from should be affirmed insofar as it dismissed all claims other than that predicated on section 36(b), but reversed insofar as it dismissed that claim.[11] Thus I dissent from the judgment of this court insofar as it affirms the dismissal of the section 36(b) claim.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

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11. I also agree that the district court did not abuse its discretion by denying plaintiff leave to make subsequent demand on the directors and to replead.

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No. 82-1200

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

DAILY INCOME FUND, INC. and REICH & TANG, INC.,

Petitioners,

—v.—

MARTIN FOX,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

JOINT APPENDIX

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Counsel for Respondent

PETITION FOR CERTIORARI FILED JANUARY 17, 1983.
CERTIORARI GRANTED MARCH 7, 1983.

TABLE OF CONTENTS

Docket Entries

District Court Docket Entries

4-30-81—Filed complt. issued summons & Notice pur. to 28 USC 636(c).

5-11-81—Filed summons with marshals return Via Certified Mail #0143536, served: Daily Income Fund, Inc. on 5-5-81, Reich & Tang Inc. on 5-5-71 #0143476

6-4-81—Filed stip. & order ext. time of defts. to answer the complt. to 6-30-81. So ordered Pierce, J.

6-29-81—Filed deft's Daily Income Fund's Notice of Motion to Dismiss this action. (sent to judge's chambers)

7-1-81—Fld Notice by dft Reich of joinder in the motion to dsm

7-14-81—Filed pltff's Memorandum in opposition to deft's motion to dismiss. (sent to judge's chambers)

7-15-81—Filed REPLY MEMORANDUM in Support of Motion to Dismiss: Rule 23.1 FRCP. for deft. Daily Income Fund, Inc.

11-30-81—Fld NOTICE OF REASSIGNMENT TO JUDGE DUFFY m/n

3-29-82—Fld Opinion & Order #52979 . . . Defts motion to dismiss is granted & pltff is denied leave to file an amended complt . . . . Duffy, J. m/n

4-6-82—Fld. JUDGMENT . . . that the complt is hereby dismissed and also that pltff. is denied leave to file an amended complt . . . Clerk. Judgment entered 4-7-82

4-12-82—Fld pltffs N/A to the USCA, 2nd Cir. from the order dated 3-26-82 & ent 3-29-82 Mailed copy to: Seward & Kissel; & Pollack & Kaminsky

4-20-82—Fld Notice that the orig. record on appeal has been certified & transmitted to the USCA, 2nd Cir. on 4-20-82

4-26-82—Fld pltffs Amended N/A to the USCA, 2nd Cir. from the judgment ent 4-6-82 . . . Mailed copy to: Seward & Kissel; & Pollack & Kaminsky

Court of Appeals Docket Entries

4-19-82—Copies of district court docket entries and notice of appeal on behalf of appellant Fox, filed

4-19-82—Copy of receipt filed re: payment of docket fee

4-19-82—Appellant Fox Form C, filed (w/pfs)

4-19-82—Appellant Fox Form D, filed (w/pfs)

4-19-82—Court Reporter Smalls form E, filed

4-20-82—Record on appeal filed—original papers of district court

4-29-82—Amended notice of appeal and district court docket entries on behalf of appellant Fox, filed

5-3-82—Scheduling Order #1, PC filed

5-26-82—Appellant Fox, brief, filed (w/pfs)

5-26-82—Appellant Fox, joint appendix, filed (w/pfs)

6-24-82—Appellee Daily Income Fund, Inc., brief, filed (w/pfs)

6-25-82—Notice that appellee Reich & Tang, Inc. joins in brief of appellee Daily Income Fund, Inc., filed

6-29-82—Appellant Fox reply brief, filed (w/pfs)

6-30-82—Appellant Fox corrected reply brief, filed (w/pfs)

9-16-82—Case argued before Judges, Feinberg, Friendly and Kaufman

10-26-82—Judgment reversed & remanded by published signed opinion Judge Kaufman C.J. filed

10-26-82—Judgment filed

11-1-82—Appellant Fox bill of Costs (w/pfs) filed

11-16-82—Appellee Reich & Tang, Inc. and Daily Income Fund, Inc. Notice of motion for stay of issuance of mandate (w/pfs) filed

11-16-82—Appellant Fox statement of costs filed

11-22-82—Appellant Fox opposition to motion for stay of issuance of mandate (w/pfs) filed

11-24-82—Order granting appellee Reich & Tang motion for stay of mandate until 30 days after the date of this order filed. (Dec. 24)

1-5-83—Mandate issued. (Judgment, opinion, statement of costs)

1-14-83—Mandate receipt received (mandate issued 1-5-83)

1-31-83—Appellees Daily Income notice of filing petition for writ of certiorari in Supreme Court, docket #82-1200 filed

3-10-83—Certified copy of order from Supreme Court granted a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted filed

Complaint

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

MARTIN FOX

Plaintiff,

—against—

REICH & TANG, INC. and DAILY INCOME FUND, INC.,

Defendants.

Plaintiff Demands Trial by Jury

Plaintiff, by his attorneys, Milberg Weiss Bershad & Specthrie, alleges as follows on information and belief, except as to the allegations of Paragraph 3, which are alleged on knowledge.

1. This Court has jurisdiction under the Investment Company Act of 1940 as amended, 15 U.S.C. § 80a-1 *et seq.* ("the Act"), and in particular § 36 and § 44 thereof, 15 U.S.C. 80a-35 and § 80a-43.

2. This cause of action arises under the Act and in particular under § 36 thereof.

3. Plaintiff is a shareholder of defendant Daily Income Fund, Inc. ("the Fund") and has been a shareholder of the Fund at all relevant times herein. Plaintiff brings this action on behalf of the Fund.

4. The Fund is a divesified open-end investment company incorporated under Maryland law. Its principal place of business is located at 230 Park Avenue, New

York, New York 10169. It is registered under the Act and is the type of investment company commonly referred to as a money market fund.

5. The Fund's investment objective is to seek to obtain high current income to the extent consistent with the presevation of capital. The Fund invests in a portfolio of short-term money market instruments, including U.S. government and federal agency obligations, obligations of major banks, and prime commercial paper. As of April 15, 1981, the total assets of the Fund were approximately $775,000,000.

6. Defendant Reich & Tang, Inc. ("R&T") is the Investment Adviser to the Fund. R&T is a Delaware corporation with its principal place of business at 230 Park Avenue, New York, New York 10169.

7. During all times relevant herein, R&T received from the Fund an annual management fee equal to 1/2 of 1% of the Fund's net assets. Thus, as of April 15, 1981, the Fund was obligated to pay R&T, pursuant to the advisory agreement, fees at the rate of approximately $3,875,000 per year. During the fiscal year ended June 30, 1980 R&T received over $2,000,000 in management fees from the Fund.

8. Unlike most other investment companies, the management of the assets of a money market fund, such as the Fund herein, does not require the detailed analysis of industries nor of complex industrial companies and the concomitant retention of a large staff of highly paid and sophisticated securities analysts. Indeed, the assets of the Fund are, and have been, invested in a relatively concentrated manner in fixed income obligations maturing in one year or less. In the ordinary course of operations, decisions to purchase are made on the same day that funds are received.

9. The assets of the Fund have undergone an enormous increase in a short period of time. As of June 30, 1978, the Fund's net assets were approximately $75 million, whereas on April 15, 1981, they had soared to over $775,000,000.

10. As a result of the tremendous increase in the assets of the Fund, the compensation paid and payable to R&T has increased enormously and disproportionately to the services rendered by R&T.

11. Because of the limited number, nature and variety of the Fund's investments, the investment decisions of the Fund can be made by a single person, or, at most, a handful of persons. The research and advisory activities of R&T are merely routine and administrative in nature, do not require any significant expertise or investment acumen, are performed by R&T for other of its accounts, and consist principally of purchasing and "turning over" money market instruments with a limited number of institutions. The incremental cost to R&T of performing these services for the Fund is minimal. In short, the investment advice provided by R&T is not worth the fees paid for that advice by the Fund and has not been worth the fees paid during the period covered by this complaint. Other advisers render similar or superior services for lesser rates.

12. The advisory fees paid by the Fund to R&T are exorbitant, unreasonable, excessive and completely disproportionate to the services rendered in return therefor.

13. Pursuant to § 36(b) of the Act, R&T has a fiduciary duty with respect to the receipt of compensation from the Fund. By virtue of the foregoing, R&T has breached its fiduciary duty to the Fund.

14. No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this

action for the reason that no such demand is required under § 36(b) of the Act. Moreover, all of the directors are beholden to R&T for their positions and have participated in the wrongs complained of in this action. Their initiation of an action like the instant one would place the prosecution of this action in the hands of persons hostile to its success.

WHEREFORE, plaintiff prays for judgment

1. requiring R&T to pay to the Fund its damages;

2. awarding plaintiff the costs and expenses of this action, including reasonable attorneys fees; and

3. awarding plaintiff such other and further relief as the court may deem just and proper.

Dated: New York, New York
April 30, 1981

MILBERG WEISS BERSHAD & SPECTHRIE
Attorneys for Plaintiff
By: Signature illegible
A Member of the Firm
One Pennsylvania Plaza
New York, New York 10119
(212) 594-5300

STATE OF NEW YORK,
COUNTY OF NEW YORK, SS.:

DAVID J. BERSHAD, being duly sworn, deposes and says: I am a member of the firm of Milberg Weiss Bershad & Specthrie, attorneys for plaintiff; I have read the foregoing complaint and know the contents thereof; the same is true to my knowledge except as to matters stated to be on information and belief, and as to those matters, I believe them to be true; the reason that this verification is made by plaintiff's attorneys is that plaintiff is not in the county where his attorneys have an office.

/s/ ____________________
David J. Bershad

Sworn to before me this
30th day of April, 1981.

/s/ Lucille Glover

LUCILLE GLOVER
Notary Public State of New York
No. 4715326
Qualified in Suffolk County
Term Expires March 30, 1982

Decision of the District Court

No. 81 Civ. 2602 (KTD).

United States District Court,
S. D. New York.

March 29, 1982.

MARTIN FOX,

Plaintiff,

—v.—

REICH & TANG, INC. and Daily Income Fund, Inc.,

Defendants.

Money market investment company shareholder brought derivative action against the company and the investment adviser to the company to recover allegedly excessive advisory fees paid by the company to the investment adviser. On the defendants' motion to dismiss, the District Court, Kevin Thomas Duffy, J., held that: (1) the shareholder was required to make demand on the company board of directors prior to bringing suit, and (2) the shareholder's failure to make such a demand was not excused by his unsubstantiated allegtion that all the company directors were involved in the wrongdoing and were necessarily hostile to his claim.

Motion granted.

Milberg, Weiss, Bershad & Specthrie, New York City, for plaintiff; Richard M. Meyer, New York City, of counsel.

Seward & Kissel, New York City, for defendant Reich & Tang, Inc.; Anthony R. Mansfield, New York City, of counsel.

Pollack & Kaminsky, New York City, for defendant Daily Income Fund, Inc.; Daniel A. Pollack, Edward T. McDermott, Frederick P. Schaffer, New York City, of counsel.

OPINION & ORDER

KEVIN THOMAS DUFFY, *District Judge*:

Martin Fox, a shareholder of Daily Income Fund, Inc. ("Fund"), sued the Fund, a money market investment company, and Reich & Tang, Inc. ("R&T"), the investment adviser to the Fund, to recover allegedly excessive advisory fees paid by the Fund to R&T. Plaintiff's derivative suit is premised on Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b), which places a fiduciary duty on an investment adviser with respect to compensation for services.[1] R&T is alleged to have breached that duty.

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1 15 U.S.C. § 80a-35(b) provides in relevant part:

> (b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or

Defendants move to dismiss plaintiff's complaint for failing to plead that a demand was made on the Fund's board of directors prior to the filing of its complaint. Federal Rule of Civil Procedure 23.1 expressly states that a derivative suit complaint:

> shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . . and the reasons for his failure to obtain the action or for not making the effort.

Plaintiff concedes that no demand was made and suggests that Section 36(b) does not require such a demand.

The issues presented to this Court are two-fold: one, whether a demand is required in a Section 36(b) action and, two, if a demand is mandated, whether plaintiff is excused from the strictures of Fed.R.Civ.P. 23.1. The

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by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

* * * * * * *

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

answers to these questions have apparently resulted in a split within this district. Judge Ward recently held in *Markowitz v. Brody, et al.*, 90 F.R.D. 542 (S.D.N.Y.1981) that Section 36(b) does not obviate the need for a Rule 23.1 demand. In direct contrast, Judge Lasker states in dictum that "a demand on the directors of the Fund was not intended to be a prerequisite to suit under § 36(b)." *Blatt v. Dean Witter Reynolds Intercapital Inc., et al.*, 528 F.Supp. 1152, 1155 (S.D.N.Y.1981). Plaintiff argues that the *Blatt* decision should control this case for the following reasons: (1) the board of directors inability to terminate a Section 36(b) action renders any demand futile; (2) the legislative history supports plaintiff's contentions; and (3) a suit maintained under Section 16(b), an analogous section, need not comply with Rule 23.1. I do not find any of these arguments to be persuasive.

DISCUSSION

Before I begin to address plaintiff's three arguments, I must start my discussion of the question presented neither with the particular section of the Investment Company Act in issue nor with the Federal Rules of Civil Procedure, but with the overall congressional intent behind the Investment Company Act and its requirement that there be "unaffiliated" persons on the board of directors of investment companies. Clearly in mandating this type of membership on the decision making board of an investment company, Congress recognized the need for protection of investors from unscrupulous investment advisors who might be in a position to mulct the public investor. The advisor to an investment company is entrusted with enormous amounts of money collected from the public shareholders and also with the day-to-day management of

those funds. S.Rep.No.184, 91st Cong., 1st Sess. (1969) *reprinted in* [1970] U.S.Code Cong. & Admin.News, 4897, 4903, 4910. The temptation for self dealing whether through inflated fees or other nefarious schemes is self-evident.

It was to inhibit such self dealing that Congress insisted that directors unaffiliated with either the investment advisor or the Fund's principal underwriter constitute forty percent of the board of an investment company, 15 U.S.C. § 80a-10. "Since the adviser and underwriter are usually the same or related entities, a majority of the directors of most funds [including the Daily Income Fund] are unaffiliated with their managers." S.Rep.No.184, 91st Cong., 1st Sess. (1969) *reprinted in* [1970] U.S.Code Cong. & Admin.News at p. 4901. Thus, under the statutory mandate the board of directors of an investment company is to be the first line of defense for the individual investor against any self dealing onto which an advisor might be tempted. *Fogel v. Chesnutt*, 668 F.2d 100 at 104 (2d Cir. 1981); *Moses v. Burgin*, 445 F.2d 369, 376 (1st Cir.), *cert. denied*, 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed. 2d 547 (1971).

To require that an individual shareholder must first bring a problem to the board of an investment company therefore is not unreasonable. The unaffiliated directors can easily solve the problem (if it be real) without the need for litigation and its concomitant expense to the investment company. Thus, absent extraordinary circumstances, a Rule 23.1 demand is a *sine qua non* in this type of litigation. To hold otherwise is to rule that the congressional enactment of the Investment Company Act is, in the main, ineffective, and the arguments advanced by plaintiff do not lead to such an anomalous result.

1. *Termination of a Section 36(b) Suit*

Mr. Fox correctly states that a Section 36(b) suit cannot be terminated by the Fund's board of directors. *Burks v. Lasker,* 441 U.S. 471, 484, 99 S.Ct. 1831, 1840, 60 L.Ed.2d 404 (1979); *Markowitz, supra*, 90 F.R.D. at 559. However, it does not logically follow that this safeguard obliterates any need for compliance with Rule 23.1. Even assuming, as plaintiff suggests, that the Fund's board of directors, which consists of three disinterested and two interested members, are hostile to his claim, this is not adequate justification for abandonment of the Federal Rules of Civil Procedure. The underlying basis for imposing the demand requirement on a derivative suit plaintiff extends beyond providing an opportunity for director termination. Directors should be given an opportunity to redress an aggrieved plaintiff without resort to litigation, *Untermeyer v. Fidelity Daily Income Trust, et al.*, 79 F.R.D. 36, 42 (D.Mass.1978), or to institute a private right of action themselves.[2] Acceptance of plaintiff's argument would foreclose any opportunity for prelitigation director involvement and as such is untenable.

2. *Lesiglative History*

Mr. Fox's bare contention that a demand on the Fund director's in a Section 36(b) suit is futile and consequently unnecessary and unreasonable, is not sufficient reason to ignore Rule 23.1. A "statute should be so construed as to harmonize with the Federal Rules if that is at all feasible." 7 Moore's *Federal Practice* ¶ 86.04[4] at 4966.

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2 It is unsettled whether or not the directors are empowered to maintain a private right of action. *Fogel v. Chestnutt*, 668 F.2d 100, 112, (2d Cir. 1981); *Markowitz, supra*, 90 F.R.D. at 557 n.12; *Untermeyer, supra*, 79 F.R.D. at 46 n.30.

Section 36(b) silence on the necessity of demand on the directors assumes compliance with Rule 23.1. The Federal Rules may, however, be superseded by congressional enactments that "abridge, enlarge or modify any substantive right." 28 U.S.C. § 2072.

> [I]t is plain to the Court that a security holder's right to sue under Section 36(b) would in no way be modified or abridged within the meaning of 28 U.S.C. § 2072 simply by requiring compliance with Rule 23.1 . . . Section 2072 is not triggered by an instance where application of the federal rules would be unreasonable, but only in a case where the rules directly conflict with substantive rights. No such conflict exists here.

Markowitz, supra, 90 F.R.D. at 555.

The legislative history provides scant basis for concluding that statutory disharmony exists with the traditional demand requirement. Plaintiff cites passages from a Senate Committee Report expressing guarded concern for the directors' ability to "secure changes in the level of advisory fee rates in the mutual fund industry." H.R.Rep.No.2337, 89th Cong., 2d Sess. (1966) at 131. Congress's proper concern with the issue of investment adviser compensation does not raise the presumption that Congress intended to abrogate Rule 23.1 nor has plaintiff presented this Court with any language supporting such a presumption.

In 1970, Section 36(b) was added to the Investment Company Act to "specify that the adviser has a fiduciary duty with respect to compensation for services of other payments paid by the fund . . . to the adviser." S.Rep.No.184, 91st Cong., 1st Sess. (1969), *reprinted in*

[1970] U.S.Code Cong. & Admin.News at 4902. The enactment of Section 36(b),

> is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interests of its shareholders from the directors of such company to the judiciary.

Id. at 4903. This legislative history supports defendants' position that the congressional motivation behind Section 36(b) was to combine forces between the unaffiliated directors and the Federal courts to adequately and equitably supervise the amount of advisory fees. Plaintiff's inference that this supervision can only occur at the sacrifice of Rule 23.1 is unreasonable and unwarranted. It would indeed be inconsistent with the expressed motives of the 1970 Amendments "to have been willing to rely largely upon 'watchdogs' [unaffiliated directors] to protect shareholder interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled." *Burks, supra*, 441 U.S. at 485, 99 S.Ct. at 1840.

Judge Lasker's decision in *Blatt* ignored the congressional imperative for independent management of money market funds and mistakenly presumed, in reliance on *Boyko v. Reserve Fund, Inc.*, 68 F.R.D. 692 (S.D.N.Y.1975) (LPG), that the directors of an investment company are uniformly antagonistic to "an action

against the Fund's advisors for breach of fiduciary duty with respect to the receipt of compensation." *Id.* at 696. Section 10 of the Investment Company Act which mandates that directors unaffiliated with both the investment advisor and the fund's principal underwriter comprise forty percent of an investment company's board of directors, refutes on its face the presumption of hostility found in both the *Blatt* and *Boyko* decisions. Unless plaintiff is prepared to contest the true "disinterest" of each unaffiliated director, these independent board members will continue to examine with a discerning eye, as Congress intended, the payments of advisory fees. Without diligent observation of Rule 23.1 these directors will be denied an opportunity to fulfill the congressional mandate.

The importance of director involvement in the instant case is underscored in Section 36(b)(2), which provides that director approval of any advisory fees "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). This provision permits the court to scrutinize the directors judgment in approving adviser compensation and to evaluate whether the "deliberations of the directors were a matter of substance or a mere formality." S.Rep.No.184, 91st Cong., 1st Sess. (1969) *reprinted in* [1970] U.S.Code Cong. & Admin.News at 4910. Rule 23.1, which fosters director input, is crucial to the court's determination and despite plaintiff's arguments, it will not be ignored.

3. *Section 16(b)*

Plaintiff's final argument rests on an ill conceived analogy between Section 16(b)[3] of the Securities Exchange

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3 "Section 16(b) authorizes actions on behalf of a corporation to recover short-swing profits realized by corporate insiders as a

Act of 1934, 15 U.S.C. § 78p(b), and Section 36(b). Plaintiff cites cases for the proposition that Rule 23.1 does not apply to Section 16(b) cases, *Dottenheim v. Murchison*, 227 F.2d 737 (5th Cir. 1955), *cert. denied*, 351 U.S. 919, 76 S.Ct. 712, 100 L.Ed. 1451 (1957); *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016, 74 S.Ct. 872, 98 L.Ed. 1138 (1954). However, these cases dealt with the contemporaneous ownership requirement of Rule 23.1 and not the demand clause at issue here. Thus, plaintiff's reliance on this case law is misplaced. This crucial distinction destroys plaintiff's suggested analogy between Section 16(b) and Section 36(b).

I am convinced that Rule 23.1 and Section 36(b) can and should co-exist compatibly. Plaintiff's arguments do not persuade me otherwise. Plaintiff's failure to make a Rule 23.1 demand on the fund directors is grounds for dismissal of the complaint unless Mr. Fox's failure to make such a demand may be excused by some extraordinary circumstances.

Plaintiff's complaint states at paragraph 14:

> No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this action for the reason that no such demand is required under § 36(b) of the Act. Moreover, all of the directors are beholden to R&T for their positions and have participated in the wrongs complained of in this action. Their initiation of an action like the instant one would place the prosecution of this action in the hands of persons hostile to its success.

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result of their purchases and sales of the corporation's equity securities." *Markowitz, supra*, 90 F.R.D. at 551.

This averment, besides being inconsistent with plaintiff's argument that the directors cannot maintain their own action, presents no adequate grounds for disobedience with Rule 23.1. The contention that all the Fund directors are involved in the wrongdoing and necessarily hostile to plaintiff's claim is unfounded. First of all, this presumption is contrary to the congressional entrustment of surveillance responsibilities to the unaffiliated directors discussed *supra*. *Burks, supra*, 441 U.S. at 486, 99 S.Ct. at 1841. Secondly, plaintiff's only proof of the potential hostility of the Fund directors to the instant case is found in the Fund's proxy statement dated September 4, 1981. This statement, issued four months after plaintiff filed his complaint discusses the instant litigation: "The Manager and the Corporation believe that the advisory fees paid by the Corporation have not been and are not excessive, and the Manager and the Corporation intend to deny and contest the material allegations of the complaint." at p. 10. This post-complaint hindsight cannot excuse Mr. Fox's failure to make a demand on the directors before filing his complaint.

Plaintiff has presented no justification for his noncompliance with Rule 23.1. Plaintiff alternatively requests that if this Court rules unfavorably, leave be granted to file an amended complaint. The rule in this Circuit is that leave to file amended complaints is usually freely granted absent prejudice to the parties. *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 856 (2d Cir. 1981). In the instant case, prejudice to the directors would result from plaintiff's dilatory amendment. One of the purposes of Rule 23.1 is to allow the directors to respond to plaintiff's claim prior to the initiation of a lawsuit. Allowing plaintiff to now file an amended complaint

would make a mockery of the demand requirement. *See Shlensky v. Dorsey*, 574 F.2d 131, 141 (3d Cir. 1978); *Weiss v. Temporary Investment Fund, Inc.*, 520 F.Supp. 1098 (D.C.Del.1981).

Thus, defendants' motion to dismiss is granted and plaintiff is denied leave to file an amended complaint.

SO ORDERED.

Decision of the Court of Appeals

No. 74, Docket 82-7296.

United States Court of Appeals,
Second Circuit.

Argued September 16, 1982.
Decided October 26, 1982.

MARTIN FOX,

Plaintiff-Appellant,

—v.—

REICH & TANG, INC. and
DAILY INCOME FUND, INC.,

Defendants-Appellees.

Shareholder appealed from dismissal by the United States District Court for the Southern District of New York, Kevin Thomas Duffy, J., 94 F.R.D. 94, of shareholder's action to recover allegedly excessive fees paid by investment company to its adviser. The Court of Appeals, Irving R. Kaufman, Circuit Judge, held that: (1) investment company did not possess right of action under section of Investment Company Act of 1940 that provides right of action to recover excessive fees by Securities and Exchange Commission or by security holder, and (2) demand requirement of Federal Rule of Civil Procedure

governing derivative actions was inapplicable to shareholder's suit.

Reversed and remanded.

Richard M. Meyer, New York City (Milberg, Weiss, Bershad & Specthrie, New York City, of counsel), for plaintiff-appellant.

Daniel A. Pollack, New York City (Pollack & Kaminsky, Frederick P. Schaffer, New York City, of counsel), for defendant-appellee Daily Income Fund, Inc.

Seward & Kissel, New York City (Anthony R. Mansfield, New York City, of counsel), for defendant-appellee Reich & Tang, Inc.

Before FEINBERG, *Chief Judge,* and
FRIENDLY and KAUFMAN, *Circuit Judges.*

IRVING R. KAUFMAN, *Circuit Judge:*

This case presents an issue of first impression in this Circuit. The question before us is whether, in a shareholder action brought pursuant to § 36(b) of the Investment Company Act of 1940 to recover allegedly excessive fees paid by an investment company to its adviser,[1] the

1 Section 36(b) imposes upon the investment adviser of a registered investment company "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). It creates a cause of action for breach of that duty, *id.*, and specifically limits "[a]ny award of damages . . . to the actual damages resulting from the breach of fiduciary duty[,] . . . in no event exceed[ing] the

shareholder plaintiff is required to plead that a "demand" was made on the company's board of directors prior to filing of the complaint.[2] At first blush, resolution of this question would seem to require merely clarification of a technical pleading rule. As our discussion makes clear, however, analysis of the issue is not uncomplicated, nor is our conclusion without important ramifications for suits brought pursuant to § 36(b).

I

Because this case comes to us from a dismissal at the pleading stage, the factual record is sparse. Martin Fox, a shareholder of Daily Income Fund, Inc. ("the Fund"), brought this action on behalf of the Fund to recover allegedly excessive fees paid by the Fund to its investment adviser, Reich & Tang, Inc. ("R & T"). The Fund, an open-end investment company of the type commonly referred to as a "money-market fund," pursues as its basic business strategy the goal of achieving high current income levels while preserving capital. To this end, it invests in a portfolio of short-term money market instruments, principally United States government and federal agency obligations, obligations of major banks, and prime commercial paper. The Fund experienced a dramatic surge in its assets, in a relatively short period of

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amount of compensation or payments received from [the] investment company. . . ." The legislative history reveals that Congress created this somewhat particularized fiduciary duty with specific reference to the recurring problem of payment of excessive adviser and management fees, *e.g.*, S.Rep. No. 184, 91st Cong., 1st Sess. 5-6 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News 4897, 4901-02.

2 This pleading requirement in the federal courts is embodied in Federal Rule of Civil Procedure 23.1, the text of which is set out at note 6.

time. As of June 30, 1978, the Fund's net assets were approximately $75 million. Less than three years later, on April 15, 1981, they had reached a level of $775,000,000. Precisely this sort of "dramatic growth"[3] impelled enactment of the 1970 amendments to the Investment Company Act of 1940, and, in particular, § 36(b), which created a cause of action for return of excessive adviser fees. Because fees are usually calculated as a percentage of assets, substantial portfolio appreciation brings with it the risk of unduly high adviser compensation. *See* S.Rep. No. 184, 91st Cong., 1st Sess. 6 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4902; *see also* J. Barnard, Jr., *Reciprocal Business, Sales Charges and Management Fees,* in 1966 Fed. B.A. Conference on Mutual Funds 127-29.

Despite this substantial increase in Fund assets, no adjustment was made in the rate at which R & T was to be paid for investment advice and other management services rendered. R & T's fee was originally set one-half of one percent of the Fund's net assets, and it remains fixed at that rate. Consequently, yearly payments by the Fund to its adviser increased from approximately $375,000 in

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3 S.Rep. No. 184, 91st Cong., 1st Sess. 3 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4899. After passage of the Investment Company Act of 1940, the industry experienced a period of relative stability. During the first year 436 companies registered, pursuant to the Act. At the end of fiscal year 1959, the number of companies had increased to only 453 with aggregate assets of about $20,000,000,000. By 1966, just seven years later, 727 companies were registered, representing assets of nearly $50 billion. 1966 SEC Ann.Rep. 100. Not surprisingly, that same year Congress requested the Securities and Exchange Commission to investigate this matter. The SEC's findings, and recommendations for legislative action are contained in *Report on the Public Policy Implications of Investment Company Growth, reprinted in* H.R.Rep. No. 2337, 89th Cong., 2d Sess. (1966) *("1966 SEC Report").*

1978, to a projected $3,875,000 in 1981. During the fiscal year ending June 30, 1980, R & T received more than $2,000,000 in management fees from the Fund. It is this extraordinary leap in fees of which Fox complains.

Fox's complaint alleged that management of the assets of a money market fund requires no detailed analysis of industries (or of large individual industrial concerns), nor the retention of a large staff of highly paid, sophisticated securities analysts. Essentially, he claimed that investment decisions are more or less routine, concentrated as they are in the relatively limited realm of "turning over" money market investments with a small number of institutions. In short, Fox alleged that R & T was continuing to provide the services it had always rendered, for what had become an exorbitant amount of money.

Rather than approach the Fund's directors with his grievance, Fox chose to allege in his complaint that no "demand" is required under § 36(b).[4] In response, the

4 Fox's complaint asserted, in addition to this legal conclusion, that "all of the [Fund's] directors are beholden to R & T for their positions and have participated in the wrongs complained of in this action. Their initiation of an action like the instant one would place the prosecution of this action in the hands of persons hostile to its success." Apparently by way of response, the Fund notes that a majority of its Board of Directors, three of five, are "disinterested directors." We need not deal with the effect of these statements. Some courts have held demand will be excused when a plaintiff shows that a majority of the investment company's directors possess an interest in the subject matter of the lawsuit sufficient to conclude that it would have been futile to ask for board action. *E.g.*, *Markowitz v. Brody*, 90 F.R.D. 542, 556 (S.D.N.Y. 1981). Yet, the mere presence of a majority of directors not directly employed by the adviser may not automatically result in the conclusion that a demand will be required. *See Lewis v. Curtis*, 671 F.2d 779, 785-86 (3d Cir. 1982). Because we agree with Fox that a § 36(b) action is exempt from the director demand requirement of Rule 23.1, we do not pass on the excuse issue.

Fund (later joined by R & T) moved to dismiss for failure to comply with Rule 23.1. After noting that the issue had resulted in a split among the district courts in this Circuit,[5] Judge Duffy concluded that a Rule 23.1 demand was required in a § 36(b) suit, and dismissed the complaint. Fox appealed. For the reasons stated below, we disagree with the district court's conclusion, 94 F.R.D. 94, and reverse.

II

We begin by noting that the Rule 23.1 demand requirement applies only when a corporation or association has "failed to enforce a right which may properly be asserted by it."[6] We agree with Fox that the rule applies only when

5 Indeed, the conflict between previous district court cases could not be more stark. In *Markowitz v. Brody, supra*, 90 F.R.D. at 554-55, Judge Ward concluded that Rule 23.1 applies to § 36(b) shareholder suits. *Accord, Gartenberg v. Merrill Lynch Asset Management, Inc.*, 91 F.R.D. 524, 526-28 (S.D.N.Y.1981). In direct contrast, Judge Lasker has stated: "a demand on the directors of the fund was not intended to be a prerequisite to suit under § 36(b)." *Blatt v. Dean Witter Reynolds Intercapital, Inc.*, 528 F.Supp. 1152, 1155 (S.D.N.Y.1982) (dictum). *Cf. Boyko v. Reserve Fund, Inc.*, 68 F.R.D. 692, 696 (S.D.N.Y.1975) (Gagliardi, J.) (when at least one affiliated or interested director on mutual fund board, futility of demand will be presumed, and, therefore, Rule 23.1 will be satisfied).

6 Fed.R.Civ.P. 23.1 provides, in its entirety:

> Derivative Actions by Shareholders
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> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer

the specified entity has an opportunity to "assert," in a court, the same action under the same rule of law on which the shareholder plaintiff relies. Thus, if the Fund may not sue pursuant to § 36(b), no demand upon its board of directors will be required. In rejecting the Fund's argument that even if it cannot bring an action under § 36(b), a demand must be made upon its directors to utilize other, informal means to "enforce its right" to return of excessive adviser fees, Brief of Defendant-Appellee Daily Income Fund, Inc. at 5-6,[7] we announce no

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jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

7 As indicated, we disagree that availability of informal methods of attempting to recoup excessive adviser fees is sufficient to trigger the demand requirement of Rule 23.1. Moreover, we find the examples given by the Fund—negotiating with the Adviser to obtain a refund, and terminating the contract, Brief for Defendant-Appellee Daily Income Fund, Inc. at 5-6—not persuasive. Negotiations may well fail, and termination of the contract, although perhaps depriving the adviser of future business, may not effect the remedy sought by the shareholder plaintiff, which is the return of excessive fees. Additionally, "a mutual fund cannot, as a practical matter sever its relationship with [its] adviser." S.Rep. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4901. Moreover, given the directors' past relationship with the adviser in approving the contract in the first place, 15 U.S.C. § 80a-15(c), the

new rule of law. As long ago as the beginning of this century, the Supreme Court construed Equity Rule 94, 104 U.S. ix (1882), the precursor of Rule 23.1, and determined that its nearly identical language[8] referred to "a suit founded on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff." *Delaware & Hudson Co. v. Albany & Susq. R.R.*, 213 U.S. 435, 447, 29 S.Ct. 540, 543, 53 L.Ed. 862 (1909); *see also Ross v. Bernhard,* 396 U.S. 531, 534-35, 90 S.Ct. 733, 735-736, 24 L.Ed.2d 729 (1970).

Accordingly, we turn initially to the question whether an investment company can bring an action under § 36(b) of the Investment Company Act of 1940.

A

Our starting point, as in every case involving construction of a statute, is examination of the language utilized

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likelihood that negotiations will prove effective is highly speculative. *See Blatt v. Dean Witter Reynolds Intercapital, Inc., supra,* 528 F.Supp. at 1156 (dictum). In reaching this conclusion, we do not ignore the salutary purpose served by requiring complaining shareholders to first "activate intracorporate remedies," *Mills v. Esmark, Inc.,* 91 F.R.D. 70, 72 (N.D.Ill.1981). Rather we conclude that a demand will not be mandated unless, should intracorporate efforts prove insufficient, the corporation itself may bring suit. *Id.* (quoting *Hawes v. Oakland,* 104 U.S. 450, 460-61, 26 L.Ed. 827 (1882)).

8 Equity Rule 94 provided, in relevant part:

> Every bill brought by one or more stockholders in a corporation against the corporation and other parties *founded upon the rights which may properly be asserted by the corporation* . . . must . . . set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors . . . .

Eq.R. 94, 104 U.S. ix (1882) (emphasis added).

by Congress. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 197, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668 (1976). The second sentence of § 36(b) is quite clear that an action may be brought under that subsection only "by the [Securities and Exchange] Commission, or by a security holder of [a] registered investment company on behalf of such company."[9] No action by the investment company is

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9 The full text of § 36(b) is as follows:

15 U.S.C. § 80a-35. Breach of fiduciary duty

* * * * * * *

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or

authorized. When Congress has provided specific and elaborate enforcement provisions, and entrusted their use to particular parties, we will not lightly assume an unexpressed intention to create additional ones. *See Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n,* 453 U.S. 1, 13-15, 101 S.Ct. 2615, 2622-2624, 69 L.Ed.2d 435 (1981).

Appellee points to the words "on behalf of such company," and argues they demonstrate that the right of the shareholder created by § 36(b) is derivative, and therefore the director demand requirement of Rule 23.1 applies, as it does to other "derivative" actions in the federal courts.

The words "on behalf of" do not create by implication a statutory right of the company itself to sue, from which the stockholders' right may be said to be "derivative."

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payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

These words, which apply as much to the Securities and Exchange Commission as to a private security holder, signify only that either party so entitled to bring an action under § 36(b) must do so to seek return of excessive management fees to the company treasury and not to individual or governmental coffers. The action is not, strictly speaking, "derivative" in the sense of deriving from a right properly asserted by the corporation, but rather constitutes individual security holders as "private attorneys general" to assist in the enforcement of a duty imposed by the statute on investment advisers.

We recognize that the one Court of Appeals to have considered the question reached a different conclusion. *Grossman v. Johnson,* 674 F.2d 115 (1st Cir.), *cert. denied,* ___ U.S. _____, 103 S.Ct. 85, 73 L.Ed.2d— (1982). In rejecting the argument that because § 36(b) explicitly provides for, it therefore only permits, suit by the SEC or a security holder, the First Circuit stated:

> We cannot believe, however, that, for example, a new and independent board of directors, intent on recovering excessive fees from an investment adviser, would be precluded from suing under section 36(b).

Id. at 120. Equally cogent is our belief that this situation was regarded as so remote or unlikely that the legislature chose not to provide for it, and was wary of permitting the Fund to control the suit, *see Burks v. Lasker,* 441 U.S. 471, 483-84, 99 S.Ct. 1831, 1839-1840, 60 L.Ed.2d 404 (1979). Moreover, the *Grossman* court offers scant support for its conclusion that the Fund may sue. It refers, first, to the "on behalf of" language in the statute. We have already indicated the meaning we attach to that phrase. Similarly, we are unpersuaded by the argument that "Congress could well have believed that,

though it was appropriate to specify that the Commission and shareholders had the new statutory cause of action[,] . . . it was unnecessary to say with particularity that the company also did." *Id.* This seems totally inconsistent with what we would expect Congress to have done. If Congress had intended to provide the company with a cause of action, it would have passed a statute saying so, in which case the derivative right of a shareholder to initiate suit would have followed automatically. A mere statement of what Congress "could have believed" seems to us not enough. Congress has not expressed, anywhere at all, the policy appellee would have us adopt.

Moreover, as the First Circuit itself notes, § 36(b)(3) "directly forbids" an action against any person "other than the recipient of . . . compensation or payments [for adviser services]." Yet, the opinion relies on the proceeding in that case having been brought against "forbidden" defendants (the "disinterested" directors and the Fund itself) as support for its conclusion that a § 36(b) suit is a typical derivative suit. The idea, apparently, is that Grossman was operating under the assumption that a § 36(b) action is the standard derivative action, in which the complaining shareholder would join the company and its directors, "in the ordinary fashion," after the corporation had declined to initiate the suit as a plaintiff. *See* H. Henn, *Handbook of the Law of Corporations and Other Business Enterprises* § 358 at 750 (2d ed. 1970). It is difficult to understand how a defect in a pleading—or a misreading of § 36(b)—can take precedence over the clear dictates of a statute.

The language of a statute controls when sufficiently clear in its context. *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 201, 96 S.Ct. at 1384. Nevertheless, mindful

of our obligation to supplement application of rules of statutory construction by searching for "persuasive evidence of a contrary legislative intent," *Transamerica Mortgage Advisors, Inc. v. Lewis, supra,* 444 U.S. 11 at 21, 100 S.Ct. 242 at 247, 62 L.Ed.2d 146 we move now to an examination of the legislative history of § 36(b).

B

Prior to enactment of the Investment Company Act of 1940, open-end investment companies,[10] or mutual funds, played a minor role in the world of finance. In 1940, investment companies held assets of approximately $2.1 billion; of this sum, mutual funds accounted for $450 million. *1966 SEC Report 2.* The 1940 Act was directed at the most flagrant self-dealing and other abuses within the investment company industry. *See United States v. Deutsch,* 451 F.2d 98, 108 (2d Cir. 1971), *cert. denied,* 404 U.S. 1019, 92 S.Ct. 682, 30 L.Ed.2d 667 (1972). It prohibits, for example, most transactions between investment companies and their advisers. 15 U.S.C. § 80a-17. Generally, the Act requires at least forty percent of a fund's board of directors to be "unaffiliated" with the adviser, and it mandates that payment for management and other investment advice be the subject of a contract between the fund and the adviser which has received both shareholder and director approval, 15 U.S.C. § 80a-15(a), (c). Moreover, a duty is imposed on the directors of a fund to evaluate the terms of the adviser contract. 15 U.S.C. 80a-15(c).

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10 An "open-end" company is one which continually offers shares for sale and will redeem outstanding shares at their proportionate net asset value. 15 U.S.C. § 80a-5(a)(1).

The 1940 Act proved most successful in controlling the serious problems covered by its broad brush approach. Indeed, an ironic measure of its success has been the public's growing confidence in the investment company industry, which led to a period of extraordinary growth in the number of investors and in net asset levels of the funds. In turn, this expansion created a specific and largely unforeseen problem. Because adviser fees are usually calculated at a percentage of a fund's net assets, and vary in proportion as portfolio value goes up or down, a period of sustained industry success would—and did—yield substantially increased fees. But the Act "did not provide any mechanism by which the fairness of management contracts could be tested in court." S.Rep. No. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad.News at 4901.

What the drafters of the 1940 Act *did* foresee, in a general way, was the possibility that the future success of the industry might entail the need for statutory change. As a result, a section of the original statute provided (and still states) that the SEC may study the ramifications of "any substantial further increase in size of investment companies . . . involving the protection of investors or the public interest," and present recommendations for legislative change. 15 U.S.C. § 80a-14(b). Accordingly, in 1958, the Commission authorized the securities research unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to study investment companies and report its findings. The Wharton Report identified the salient issues, but made no proposals. Subsequently, the Commission undertook further research, and presented the results and recommendations for detailed amending legislation in its *Report on the*

Public Policy Implications of Investment Company Growth, transmitted to Congress in 1966.

The *1966 SEC Report* reiterated the Wharton unit's findings. It concluded that mangement fees tended to be fixed at the traditional level of one-half of one percent of the fund's net assets. It noted that they markedly exceeded fees charged by investment advisers to other institutional clients and the cost of management to those funds which manage themselves. Moreover, no evidence existed to demonstrate a willingness on the part of the advisers to provide services at a "reasonable" rate, not necessarily a percentage of assets. The Report further stated that the 1940 Act was not equipped to deal with this emerging problem, and that shareholder suits, although occasionally forcing settlements, basically had been ineffective. *1966 SEC Report* 84-149. To deal with this issue, the SEC recommended amending the Act to require that mangement fees be "reasonable." Reasonableness was to be determined by reference to various criteria, including the fees paid for similar services by like institutions, the nature and quality of services rendered, and any other factors determined to be appropriate in the public interest. The SEC was to have an enforcement action available to it (as in fact it does under present § 36(b)), and would also possess the right to intervene in private shareholder suits. *Id.* at 143-47. Nowhere does the Report mention an action brought by the investment company itself.

The standard of "reasonableness" proposed in the *1966 SEC Report* was contained in the first bills considered by Congress, H.R.9510, 90th Cong., 1st Sess. § 8(d) (1967) and S.1659, 90th Cong., 1st Sess. § 8(d) (1967). Not surprisingly, it was met by vigorous industry opposi-

tion, *see generally Hearings on S.1659 Before the Senate Comm. on Baking and Currency*, 90th Cong., 1st Sess., pt. 1, at 191-201 ("*1967 Senate Hearings*"); *Investment Company Act Amendments of 1967: Hearings on H.R.9510, H.R.9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 90th Cong., 1st Sess., ser. 90-21, pt. 1, at 237-43 (1967) (statement of John R. Haire, chairman-elect, Investment Company Institute), and neither bill passed. The industry claimed fees were already reasonable, the legislation would encourage "strike" suits, and the SEC would be empowered to regulate a competitive industry. *1967 Senate Hearings* at 191-92, 202. In one sense, of course, the relative merits of each side of this debate are irrelevant. The ultimate passage of § 36(b) settled the issue and expressed the legislative conclusion that imposing a "fiduciary duty" and leaving its exegesis to the judiciary[11] provided the best solution. This decision represented the compromise reached by industry repre-

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11 *E.g.*, 15 U.S.C. § 80a-35(b)(2); *see 1967 Senate Hearings* at 1016:

> It is for Congress to decide in each case just what mix of administrative and judicial participation is best adapted to the problem in hand. One end of the spectrum provides more in administrative expertise and uniformity, the other more in those qualities of restraint, freedom from bureaucratic rigidity, open-mindedness and good sense that judges like to believe are special attributes of courts.
>
> (Statement of Judge Henry J. Friendly)

The quoted language goes to the question whether case-by-case judicial evaluation of allegations of excessive adviser fees, on the one hand, or an administrative procedure which would also weigh industry-wide factors, on the other, is best suited to adjudication of shareholder complaints. Congress apparently believed, along with my brother Friendly, that courts possessed sufficient good qualities to make them appropriate forums in which § 36(b) complaints might be heard.

sentatives and the SEC. *See Hearings on H.R.11995, S.2224, H.R.13754, H.R.14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce,* 91st Cong., 1st Sess., ser. 91-33, pt. 1, at 138 (1969) ("*1969 House Hearings*"). On the other hand, that the focus of legislative inquiry, from the introduction of the first bills through a period of several years until enactment, remained fixed on this question, is of special significance for our purpose. The normal conclusion to be drawn from intensive—and exclusive—Congressional scrutiny of a particular subject is that Congress did not concern itself with others. Put differently, if the voluminous legislative history of § 36(b) and its unsuccessful predecessors persuades us that Congress's first order of business was now to make shareholder suits (and SEC enforcement actions) effective, rather than whether it might also be useful to sanction suit by a fund, we would be hard-pressed to conclude that Congress intended to empower the courts to permit a fund to sue.

It is obviously difficult, under the best of circumstances, to prove a negative. Because the extensive legislative history of § 36(b) neither approves nor disapproves suits brought directly by mutual funds, it cannot be shown to a certainty (and perhaps never to the satisfaction of those disposed to believe otherwise) that Congress foreclosed their use of the section. What *can* be shown, in this instance, is that the Congressional approach to a specific problem—excessive adviser fees—consisted of, first, identifying the source of that problem; next, determining why the 1940 Act, in other respects effective, had been and would continue to be incapable of remedying it; and finally, amending the relevant portion of the Act. If, therefore, the source of the problem is inconsistent with a

corporate right of action as a solution, we can say with confidence that Congress never intended to create one. Moreover, if the flaw in the 1940 Act was unrelated to the unavailability of a suit by the fund, our conclusion becomes virtually certain, since we know that the statutory lacuna was filled by a provision conspicuous for its failure to name the fund as a potential plaintiff.

Several years of careful study indicated that the problem derived from the peculiar nature of the mutual fund industry (seen in light of its rapid growth):

> Mutual funds, with rare exceptions, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, that are separately owned and operated. These separate organizations are usually called investment advisers. The advisers select the funds' investments and operate their businesses. For these services they receive management or advisory fees. These fees are usually calculated at a percentage of the funds' net assets and fluctuate with the value of the funds' portfolio.
>
> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the

mutual fund industry in the same manner as they do in other sectors of the American economy.

* * * * *

It is noted . . . that problems arise due to the economies of scale attributable to the dramatic growth of the mutual fund industry. In some instances these economies of scale have not been shared with investors. Recently there has been a desirable tendency on the part of some fund managers to reduce their effective charges as the fund grows in size. Accordingly, the best industry practice will provide a guide.

S.Rep. No. 184, 91st Cong., 1st Sess. 5-6 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad.News at 4901-02; *see also 1966 SEC Report* 131; H.R.Rep. No. 1382, 91st Cong., 2d Sess. 7 (1970); *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976).

Additionally, the requirement that a percentage of the directors of the investment company be "independent" of the adviser and underwriter, 15 U.S.C. § 80a-10, and that they annually approve the adviser contract, 15 U.S.C. § 80a-15, cannot seriously be expected to induce arm's-length bargaining. As the SEC long ago recognized, any so-called independent directors would "obviously have to be satisfactory to the dominating stockholders who are in a position to continue to elect a responsive board." *Petroleum & Trading Corp.*, 11 S.E.C. 389, 393 (1942); *see 1969 House Hearings*, ser. 90-22 at 696-97 (testimony of SEC Chairman Manuel F. Cohen).

In sum, the root of the excessive adviser fee problem is basically incompatible with a corporate right of action as an effective solution. We believe the Senate Committee on Banking and Currency (referring to the bill eventually passed) had in mind exactly the plaintiffs it named and no others when it stated: "[Y]our committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of [adviser] fees, there should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty." S.Rep. No. 184, 91st Cong., 1st Sess. 1 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad.News at 4898. Neither the parties' briefs nor our own research has disclosed any indication in the comprehensive legislative history of § 36(b) that suits by directors themselves were to be expected or encouraged. Although we agree with Judge Duffy that Congress intended the directors would perform a "watchdog" function, *see also Burks v. Lasker, supra,* 441 U.S. at 484, 99 S.Ct. at 1840; *Boyko v. Reserve Fund, Inc., supra,* 68 F.R.D. at 695-96 n.2, it defies logic to conclude their contemplated role included suing their advisers.

Moreover, the 1940 Act was not deficient or ineffective because a fund could not use it. By the time consideration of the 1970 Amendments was at hand, it had become clear that shareholders were hard pressed to prove a "gross abuse of trust," the standard of old § 36. *Saxe v. Brady,* 40 Del.Ch. 474, 184 A.2d 602 (1962) (Seitz, Ch.), decided under traditional corporate law concepts, provided the model adhered to by federal courts in suits alleging excessive management fees. *See Kurach v. Weissman,* 49 F.R.D. 304, 305-06 (S.D.N.Y. 1970). In *Saxe,* mutual fund shareholders challenged adviser fees amounting to one-half of one percent of net assets. The

adviser contract had been approved almost unanimously by the shareholders. Chancellor Seitz (now Chief Judge of the Third Circuit Court of Appeals) concluded that the adviser fee level must be evaluated according to the usual legal rules applicable to shareholder ratification cases:

> When the stockholders ratify a transaction, the interested parties are relieved of the burden of proving the fairness of the transaction. The burden then falls on the objecting stockholders to convince the court that no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given.

Saxe v. Brady, supra, 40 Del.Ch. at 486, 184 A.2d at 610. In concluding that plaintiffs must show "actual waste," or a fee level so high as to be "unconscionable," *id.*, the Chancellor noted that a 0.5% adviser fee rate was common and that the shareholders had approved the adviser contract virtually unanimously. *Id.* at 489, 184 A.2d at 611-12. Since these determinative factors were inevitably present, showing "actual waste" and overcoming a presumption of "sound business judgment" was well nigh impossible. *Kurach v. Weissman, supra*, 49 F.R.D. at 305-06; *Goodman v. Von Der Heyde*, [1969-1970 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 92,541 (S.D.N.Y.1969); *Lessac v. Television-Elecs. Fund*, [1967-1969 Transfer Binder] Fed.Sec.L.Rep. ¶ 92,305 (S.D.N.Y.1968); *see Rosenfeld v. Black*, 445 F.2d 1337, 1345-46 (2d Cir.1971). Recognizing that shareholder plaintiffs had difficulty sustaining their burdens, Congress changed only the standard of duty. *Cf. Burks v. Lasker, supra*, 441 U.S. at 483-84, 99 S.Ct. at 1839-1840 (1979).

Despite the long odds, shareholders did sue for return of allegedly excessive fees. Starting in 1959, over fifty suits were instituted under common law principles and pursuant to the 1940 Act. *1966 SEC Report* 132. What happened is instructive. Advisers were sometimes willing to settle, because even *Saxe* left open the possibility that the point might be reached at which "profits . . . outstripp[ed] any reasonable relationship to expenses and effort even in a legal sense." 40 Del.Ch. at 498, 184 A.2d at 616-17. Given the substantial sums at stake, this willingness is not surprising. For precisely the opposite reason—that is, the slim likelihood of success on the merits—courts felt constrained to approve settlements, even when the terms were something less than desirable. *E.g., Jurach v. Weissman, supra*, 49 F.R.D. at 305. This confluence of inconsistent, but complementary, motives resulted in reduction of adviser fees in individual cases, but the effect on the industry as a whole was insignificant. In 1967, SEC Chairman Manuel Cohen noted that "[t]he median advisory fee paid by the 59 externally managed mutual funds with net assets of $100 million or more in fiscal years ending in 1966 was still 0.48 percent, down only 0.02 percent from the traditional 0.50 percent rate." *1967 Senate Hearings*, pt. 1, at 14-15. Obviously, the pressure to settle was analytically unrelated to the identity of the plaintiff.

Our retracing of the analysis employed by Congress, and of its extensive documentation, persuades us that an investment company was not intended to possess a right of action under § 36(b). The relationship of a Fund to its adviser makes it a part of the problem in a way that precludes it from being part of the solution, at least at the

litigation stage. The provision for evaluation of the adviser contract, 15 U.S.C. § 80a-15(c), and the general tightening of the powers of disinterested directors, *e.g.*, 15 U.S.C. §§ 80a-2(a)(19); 80a-10(a); 80a-15(c), provide for "an independent check on management . . . and the representation of shareholder interests in investment company affairs," S.Rep. No. 184, 91st Cong., 1st Sess. 32 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4927. We take this language to be nothing more nor less than a declaration by Congress that it was imposing duties on the directors to run the ongoing business of the Fund in a responsible manner, and with due regard for investors. *Cf. United States v. National Ass'n of Sec. Dealers*, 422 U.S. 694, 705 n. 13, 95 S.Ct., 2427, 2436 n. 13, 45 L.Ed.2d 486 (1975)(1940 Act concerned with imposing controls on "internal management [and] practices of investment companies"). These functions and duties having proved ineffective in a particular case, at least in the eyes of the complaining shareholder plaintiff, the issue for Congressional scrutiny was how to particularize the already existing statute to make judicial relief a genuine possibility. Experience with shareholder suits had demonstrated that the *Saxe* standard, drawn from pre-existing corporate law principles but applied to the investment company industry, was useless. The fiduciary duty standard was imposed, and courts were empowered to view "all the circumstances," 15 U.S.C. § 80a-35(b)(2). The extensive number of suits brought under the earlier, less favorable law suggested that shareholders would move with alacrity pursuant to the new one. Given the nature of the problem and reasons for the 1940 Act's failure to remedy it, creating a corporate right of action

would have made little sense and we conclude Congress never intended to do so.[12]

III

We have not as yet considered the applicability of Rule 23.1 head-on. Instead, we posed the analytically precedent question, whether a Fund may use § 36(b), and thereby trigger the rule. Our answer, that Rule 23.1 does not apply because the Fund has no right of action, renders superfluous any extensive discussion of the policy behind requiring demand. Nonetheless, because we believe neither policy nor logic compels application of the demand requirement to actions for return of excessive adviser fees, we briefly discuss the distinctiveness of § 36(b).

Unlike the board in the common variety of derivative suit, the directors have no power to terminate a § 36(b) action. Other provisions of the Investment Company Act. *e.g.*, 15 U.S.C. § 80a-13(a)(3), governed by state rules to the extent they are not inconsistent with federal law, leave unanswered the question whether independent directors of an investment company may terminate suit. ***Burks v. Lasker, supra***, 441 U.S. at 483-86, 99 S.Ct. at 1839-1841. "[W]hen Congress . . . intend[ed] to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b) . . . , added to the act in 1970, performs precisely this function . . . ." *Id.* at 484, 99 S.Ct. at 1840 (citation omitted). Since directors cannot cut off a suit

12 We agree with the First Circuit, *Grossman v. Johnson, supra*, 674 F.2d at 121, that debate over the legislative history "end[s] in a draw," but we proceed under a different assumption, that § 36(b) does not permit an action by the investment company, and reach the opposite conclusion that Congress intended no demand requirement would apply.

and § 36(b) does not authorize them to institute one, and because shareholder plaintiffs are necessarily challenging fees the directors evaluated and approved, 15 U.S.C. § 80a-15; *see Rosenfeld v. Black, supra*, 445 F.2d at 1345, the traditional reason for the demand requirement simply does not apply. *See* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U.Chi.L.Rev. 168, 171-72 (1976).[13]

Moreover, although requiring demand normally imposes only minor hardship on the complaining shareholders, in a § 36(b) suit the consequences can be severe. Section 36(b) expressly limits recovery to excessive fees paid up to one year prior to the commencement of suit. 15 U.S.C. § 80a-35(b)(3). The demand requirement implies a reasonable time in which directors may analyze the issues and determine whether they believe the company has a grievance. The delay caused by this process would, in many cases,[14] have the untoward result of precluding

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13 One court, analogizing *Burks v. Lasker*, concluded that the question whether a board of directors is sufficiently "interested" in the challenged transaction to excuse demand shall be resolved by reference to "the same factors used to determine whether a court should defer to the board's decision not to pursue the action" *Lewis v. Curtis, supra*, 671 F.2d at 785. Under this view, the termination and excuse issues are functions of the same indicia of "interestedness." *Burks* may be regarded as recognizing the Congressional determination that directors in § 36(b) actions are *never* sufficiently disinterested to permit them to terminate suit, 441 U.S. at 484, 99 S.Ct. at 1840. Viewing these two principles in tandem, it is possible to infer that Congress also believed directors would always be so "interested" that demand would inevitably be "excused." This is but another way of saying Congress intended that § 36(b) suits would be *exempt* from Rule 23.1.

14 At oral argument, Fox's counsel referred to the case where the fund may have awarded a substantial one-time payment for allegedly remarkable services. No doubt other examples could be cited.

full recovery of excessive fees while the directors determined whether they had acted against the interests of the shareholders in approving the contract initially. We do not believe Congress was unaware of this pitfall.

IV

In a different contest, Justice Jackson eloquently described the origin and rationale of the derivative suit:

> Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own. It required him first to demand that the corporation vindicate its own rights, but when, as was usual, those who perpetrated the wrongs also were able to obstruct any remedy, equity would hear and adjudge the corporation's cause through its stockholder with the corporation as a defendant, albeit a rather nominal one. This remedy, born of stockholder helplessness, was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses.

Cohen v. Beneficial Loan Corp., 337 U.S. 541, 548, 69 S.Ct. 1221, 1226, 93 L.Ed. 1528 (1949). In holding that a Rule 23.1 demand will not be required in a shareholder suit brought pursuant to § 36(b) of the Investment Company Act, we do not ignore the appropriateness, in the typical derivative suit alleging corporate wrongdoing, of first asking the corporation to "vindicate" what are, after

all, "its own rights." We conclude, however, that in the unique context of a § 36(b) lawsuit, the shareholder need not afford the fund an opportunity to vindicate its rights because such a requirement would be an empty, unfruitful and dilatory exercise.

The judgment of the district court is reversed and the case is remanded.

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No. 82-1200

IN THE

Supreme Court of the United States

October Term, 1982

DAILY INCOME FUND, INC. and
REICH & TANG, INC.

Petitioners,

v.

MARTIN FOX,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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Statutes Involved

The statutes and rules involved are § 36(b) of the Investment Company Act of 1940 as amended, 15 U.S.C. § 80a-35(b), and Rule 23.1 of the Federal Rules of Civil Procedure. Section 36(b) is set forth at footnote 9, pages 21-22 of Petitioners' Appendix. Rule 23.1 is set forth at footnote 6, pages 18-19 of the Petitioners' Appendix.

Summary of Argument

The Petition seeks to burden this Court with the review of a decision the effect of which is merely procedural. The decision of the Court of Appeals does not interfere with the operation of the Investment Company Act (or any other federal statute), but rather facilitates its enforcement.

Moreover, the decision below is correct and well reasoned. It is consistent with this Court's decision in *Burks* v. *Lasker*, 441 U.S. 471 (1979), and with this Court's decisions in the implied right of action cases. Although it is true that one decision in the First Circuit and one decision in the Third Circuit are at variance with the decision below, the conflict is not of sufficient importance to warrant this Court's intercession.

ARGUMENT

After lengthy and careful consideration of the abuses of excessive advisory compensation and the inadequacies of directorial action to protect shareholders, Congress added section 36(b) to the Investment Company Act in 1970. The section provides that any security holder of an investment company, or the Securities and Exchange Commission, may bring an action to recover damages for the investment company for excessive compensation paid to the investment company's investment adviser. The section does not create a right of action which may be brought by the investment company itself.

Rule 23.1, F.R.C.P., relating to demand upon directors, applies only to those situations where a corporation fails "to enforce a right which may properly be asserted by it". These are terms of art; they refer to "a right of action existing in the corporation itself"; *Delaware & Hudson Co.* v. *Albany & Susq. R.R.,* 213 U.S. 435, 447 (1909). Where the directors are powerless to enforce the right insisted upon by the stockholder, the rule, by its very terms, as well as by the dictates of common sense, does not apply. It is manifestly futile to request directors to do that which they are powerless to accomplish.

An investment company cannot bring an action against its investment adviser under § 36(b) of the Investment Company Act. A plethora of decisions in the past decade by this Court has refused to imply private rights of action where express statutory provisions for other forms of proceeding

are provided by Congress. Thus, in *S.I.P.C.* v. *Barbour,* 421 U.S. 412, 419 (1975), the Court stated ". . . express statutory provision for one form of proceeding ordinarily implies that no other means of enforcement was intended by the Legislature." The culmination of this line of cases, of which a sampling is set forth in the margin,* was stated by the Court in *Middlesex County Sewerage Authority* v. *National Sea Clammers Association,* 101 S.Ct. 2615, 453 U.S. 1 (1981), cited approvingly by both the majority and the dissent in *Merrill Lynch, etc.* v. Curran, 102 S.Ct. 1825, 1839; dissent pp. 1848, 1849, 1853 (1982). In that case, Congress had provided statutory remedies to government officials and private citizens, just as under § 36(b) Congress entrusted enforcement to the SEC and to security holders of investment companies. This Court took special note of these provisions. It stated:

> "These Acts contain unusually elaborate enforcement provisions, conferring authority to sue for this purpose both on government officials and private citizens. . . .
>
> In view of these elaborate enforcement provisions it cannot be assumed that Congress intended to authorize by implication additional judicial remedies . . . As we stated in *Transamerica Mortgage Advisers, supra,* 'it is an elemental canon of statutory construction that where a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it.' . . . In the absence of strong indicia of a contrary congressional intent, we are compelled to conclude that Congress provided precisely the remedies it considered appropriate." (101 S.Ct. at 2623).

Thus, where express remedies are created in some detail, as in § 36(b), there can be no additional implied rights of

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* ***Touche Ross*** **v. *Redington,* 442 U.S. 560 (1979); *Cannon* v. *University of Chicago,* 441 U.S. 677 (1979); *Transamerica Mortgage Advisors* v. *Lewis,* 444 U.S. 11 (1979); *Universities Research Association* v. *Coutu,* 450 U.S. 754 (1981); *Northwest Airlines* v. *Transport Workers Union,* 451 U.S. 77 (1981); *California* v. *Sierra Club,* 451 U.S. 287 (1981); *Texas Industries* v. *Radcliff Materials,* 451 U.S. 630 (1981).**

action.* In short, the Fund itself does not have a right of action under the statute. Consequently, a demand upon the directors to initiate such an action would be a meaningless act.

Petitioners contend that, when § 36(b) was enacted, Congress recognized and implicitly incorporated into the statute the existence of a private right of action on behalf of the investment company against its investment adviser (Petition, pp. 10, 12). However, these rights of action were those which arise under various other sections of the Investment Company Act, not § 36(b); *Fogel* v. *Chestnutt,* 668 F.2d 100, 111 (2d Cir. 1981), *cert. denied,* 459 U.S. (1982) ("... we do not think § 36(b) was intended to negate implied causes of action which the courts have found under sections of the Act *other than § 36.*" Emphasis supplied). In § 36(b), Congress created a new federal standard and imposed a new duty on investment advisers requiring that they not accept excessive compensation. No showing of personal misconduct is necessary. And, contrary to the petitioner's suggestion, § 36(b) is the exclusive provision, not merely "another means" (Pet. p. 11), for recovering excessive advisory fees; *Fogel* v. *Chestnutt, supra,* 668 F.2d at p. 112.

This Court has already considered the Congressional intention in enacting § 36(b) and has held that under that section a security holder's action may not be terminated by a court simply because the board of directors or a committee thereof urge it to do so; *Burks* v. *Lasker,* 441 U.S. 471, 484 (1979):

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* *Herman & MacLean* v. *Huddleston,* Nos. 81-680 and 81-1076 (U.S. Sup. Ct. January 24, 1983), is not inconsistent with this line of cases. In *Huddleston,* this Court held that an implied right of action existed under § 10(b) of the Securities Exchange Act of 1934 even though express rights of action were contained in § 11 of the Securities Act of 1933. The court noted that § 10(b) actions had been consistently recognized for more than 35 years. Justice Marshall stated, for the Court, "The resolution of this issue turns on the fact that the two provisions involve distinct causes of action and were intended to address different types of wrongdoing." Slip Op., pp. 5-6. In the present case, the petitioners are seeking to imply for the Fund the same right of action for the identical wrongdoing expressly entrusted to the respondent's enforcement.

"And when Congress did intend to prevent board action from cutting off derivative suits it said so expressly. Section 36(b), 15 U.S.C. § 80a-35(b)(2) added to the Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to advisor's fees." (footnote omitted)

Notwithstanding this Court's statement in *Burks* v. *Lasker,* the petitioners contend that the underlying purpose of the amendments to the Investment Company Act are to confer on the directors authority for the control of litigation concerning excessive advisory fees. However, this Court's statement that Congress intended to prevent board action from cutting off derivative suits is amply supported by the legislative history. Congress felt that directorial action was ineffective in checking excessive advisory fees:

> "Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arms-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy." Sen. Rep. No. 91-184, 91st Cong., 1st Sess., p. 5 (1969).

Moreover, § 36(b) was predicated, as the Senate Committee Report states (Report of the Senate Committee on Banking and Currency No. 91-184, 91st Congress, 1st Sess. pp. 1-2), on the Securities and Exchange Commission's findings in its 1966 Report on Investment Companies. That Report; entitled "Public Policy Implications of Investment Company Growth ("PPI") (House Report No. 2337, 89th Congress, 2d Sess.) stated:

"It has been the Commission's experience in the administration of the Act that in general the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates in the mutual fund industry." (p. 131)

"The right of the Commission as well as investment company shareholders to take action against violations of the statutory standard of reasonableness is essential to effective enforcement." (p. 146)

The Committee Report left no doubt of the desirability of stockholder access to the courts (Report of the Committee on Banking and Currency, Senate Report No. 91-184, 91st Cong., 1st Sess., p. 2):

"In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.

Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty."

To be sure, Congress in the 1970 amendments to the Investment Company Act included provisions imposing stringent duties upon disinterested directors, as well as interested directors, of investment companies. And Congress believed that this would strengthen the role of disinterested directors. But there is no inconsistency between those provisions and the provisions enabling security holders to sue directly. Indeed, they are complementary means for remedying the evil which Congress was attempting to eliminate:

namely, the charging of excessive advisory fees by investment advisers.*

Moreover, although the petitioners contend that dispensing with the demand requirement imposes a major shift in the governance of investment companies, the effect of the decision is basically procedural. Thus, if a demand is made and rejected the directors can not terminate an action brought thereafter; *Evangelist* v. *Fidelity Management & Research Company,* No. 81-536-Z (D. Mass. 1982), leave to app. denied, F.2d (1st Cir. January 21, 1983).** The decision below merely expedites the shareholder's right to seek recovery.

And although the petitioners contend there is a conflict among the Circuits, that same conflict was present when this Court denied the petition for rehearing in *Grossman* v. *Fidelity Municipal Bond Fund, Inc.* on January 10, 1983. Indeed, a far stronger case for Supreme Court intervention exists where the lower courts insist upon a demand requirement, for that requirement interferes with the operation of § 36(b). On the other hand, no disruption to the congressional purpose is wrought by the decision below. The internal affairs of investment companies will continue to be governed by their boards of directors while at the same time shareholders and the SEC will possess their intended remedies to recover excessive fees extracted from those companies.

* "The unaffiliated directors, as the only potentially disinterested persons in the management of most investment companies, can and should play an active role in representing the interests of shareholders not only in connection with management compensation but in other areas where the interests of the professional managers may not coincide with those of the company and its public investors. Strengthening the voice of truly disinterested directors in investment company affairs is important to the protection of public shareholders. But even a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company's adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation." (PPI, p. 148)

** Because *Evangelist* is not yet reported, the opinion is reproduced in an appendix to this brief.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX

UNITED STATES DISTRICT COURT

DISTRICT OF MASSACHUSETTS

Civil Action No. 81-536-Z

FRANK J. EVANGELIST, JR.

vs.

FIDELITY MANAGEMENT & RESEARCH COMPANY and FIDELITY CASH RESERVES

Memorandum of Decision

ZOBEL, *D.J.*

This is a shareholder derivative suit brought against Fidelity Management & Research Company ("FMR") and Fidelity Cash Reserves (the "Trust"). Plaintiff Frank J. Evangelist, Jr., a shareholder in the Trust, alleges that FMR breached its fiduciary duty under Section 36(b) of the Investment Company Act of 1940 (the "Act"), 15 U.S.C. § 80a-35(b), because management fees paid to it by the Trust are excessive. He further claims that a proxy statement sent to the Trust's shareholders is materially false and misleading in violation of Section 20 of the Act, 15 U.S.C. § 80a-20, and Section 14 of the Securities Exchange Act of 1934, 15 U.S.C. § 78n. FMR and the Trust have moved to dismiss the 36(b) claim pursuant to Fed.R.Civ.P. 12(b)(6) and 23.1. The Trust moves alternatively for summary judgment. Both defendants seek partial summary judgment on the proxy fraud claim. They also seek dismissal of a related action (*"Evangelist I"*) filed earlier in time but alleging substantially identical

36(b) violations.[1] Without deciding the disposition of the earlier action,[2] I conclude that, as to the later action, the motion to dismiss plaintiff's proxy claim should be allowed. Defendants' motions concerning the 36(b) claim are denied.

The relevant facts are contained in the plaintiff's complaint (which must be taken as true for purposes of the motion to dismiss) and in affidavits submitted in support of the motion for summary judgment. The Trust is a diversified open-end investment company organized in December 1978 as a Massachusetts business trust. It is a "money market" mutual fund registered under the Act with the Securities Exchange Commission. The Trust invests in a portfolio of short-term money market instruments, which include government securities, commercial paper and corporate obligations. FMR is the Trust's investment adviser, its monthly fee geared toward the Trust's gross income. The fee is set by an advisory and service contract negotiated by the Trust's board of trustees, a majority of whom are "disinterested" as defined by the Act. As a result, in part, of a tremendous increase in the Trust's assets, FMR's fees have skyrocketed over the years. According to plaintiff's complaint, the fees were and are disproportionate to the relatively routine, low-cost services FMR renders.

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[1] Civ. Action No. 81-536-Z (*Evangelist I*) was filed on February 25, 1981 without plaintiff having made a demand on the Trust to institute suit. While plaintiff contended that no demand was required in a 36(b) action, I found on July 20, 1981 that one was indeed necessary if plaintiff was to go forward. Following his demand and the refusal by the trustees of the Trust to sue, plaintiff amended his complaint in *Evangelist I*, then several months later, filed a second suit, Civ. Action No. 82-912-Z (*Evangelist II*). Only the motions in connection with *Evangelist II* are decided here.

[2] Plaintiff has stipulated that *Evangelist I* should be dismissed if the Supreme Court denies *certiorari* in the case of Grossman v. Johnson, Fed.Sec.L.Rep. (CCH) ¶ 98,619 (March 29, 1982). The First Circuit held in that case that a pre-complaint demand was required in a derivative suit brought under 36(b) of the Act. The Supreme Court denied *certiorari* on October 4, 1982, but I understand that plaintiff filed a petition for rehearing. No action will be taken until the Court has acted on that.

On July 20, 1981, plaintiff mailed a letter to the Trust's board of trustees, enclosing a copy of the complaint in the related case of *Evangelist I* [3] and demanding that the board bring suit against FMR. On September 28 of that year, plaintiff's counsel met with a special committee of disinterested trustees appointed to review plaintiff's demand. On October 13, the chairman of the disinterested trustees informed plaintiff's lawyer that the committee had decided that the Trust should not institute suit against FMR. However, it had tentatively negotiated substantial reductions in FMR's fees which the board was expected to approve. Shortly thereafter, the trustees did approve new fee limitations, to become effective October 26. On April 6, 1982, plaintiff filed *Evangelist II*. The complaint states that despite the negotiated fee reduction, FMR's fees remain excessive, in violation of section 36(b) of the Act. The suit seeks damages from FMR payable to the Trust as well as attorney's fees.

Plaintiff's proxy claim concerns materials sent on February 24, 1982 to the Trust's shareholders, who were to vote on the newly negotiated contract with FMR.[4] Plaintiff alleges that the proxy statement misstates the fee revisions, pointing to disparities between a schedule of fee limitations on page 8 of the statement and a table of effective rates set forth in an affidavit submitted in connection with *Evangelist I*. No demand was made on the board of trustees in connection with the proxy claim, although plaintiff takes the position that the demand is excused.

A. The 36(b) Claim.

Defendants seek dismissal of the 36(b) claim in *Evangelist II* not on the grounds that plaintiff has failed to make a

[3] *Evangelist I*, described in footnote 1, *supra*, also attacked FMR's advisory fees. It contained no claim of proxy fraud, however.

[4] The shareholders later approved the contract with FMR by a wide margin. The effect of that approval on plaintiff's challenge, however, is not now before the Court.

demand[5] but rather that the trustees' response to that demand bars a derivative suit. First, defendants contend that the trustees' refusal to sue must be honored because it was made in good faith. Second, the renegotiation of FMR's fees amount to a satisfaction of plaintiff's demand, so that his failure to show why the fee reductions are unreasonable or made in bad faith deprives him of the ability to press his claim.

The thrust of FMR's argument in support of its motion to dismiss is that plaintiff's pursuit of his claim over trustees' rejection and in spite of the fee renegotiation fails to satisfy the demand requirement of Rule 23.1. The Trust joins in this argument, but alternatively moves for summary judgment on the ground that the trustees' response falls within the business judgment rule. Both the demand requirement of Rule 23.1 and the business judgment rule stem from the principle that primary responsibility for corporate management lies with the board of directors. They are not the same, however, carrying different legal standards, serving different purposes, and having different legal consequences. The distinction between the two is particularly important here, since both rules are invoked.

The demand requirement is essentially a requirement that a shareholder exhaust his intracorporate remedies before going to court with a derivative suit. *Galef* v. *Alexander*, 615 F.2d 51, 59 (2d Cir. 1980). Forcing the shareholder to go to directors first reinforces their position as corporate managers by giving them the opportunity to sue on behalf of

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[5] The Trust makes a passing reference to the alleged insufficiency of the demand, pointing out that the trustees received a copy of *Evangelist I*, which contained allegations concerning only FMR's initial fees, not the revised ones. The trustees were on clear notice that plaintiff intended to attack FMR's fees in general, however, and met with plaintiff's counsel on September 28, 1981 to discuss his demand. The revised fees were approved ten days after the trustees rejected plaintiff's demand October 13. Under these circumstances, no second demand is required. Any effect the fee reductions may have on plaintiff's standing to bring a derivative suit is a question distinct from whether plaintiff has made an adequate demand under 23.1.

the corporation or to remedy the problem of which plaintiff complains. Note, "The Demand and Standing Requirements in Shareholder Derivative Actions," 44 U.Chi.L.Rev. 168, 171 (1976). The demand requirement is thus primarily addressed to the question of *who* will pursue the claim—the corporation through its directors or the shareholder in a derivative suit. *See Weiss* v. *Temporary Investment Fund, Inc.,* 516 F.Supp. 665, 670 n. 13 (D.Del. 1981). The First Circuit strictly enforces the demand requirement of 23.1, excusing demand only in exceptional circumstances. *See, e.g., Grossman* v. *Johnson,* Fed.Sec.L.Rep. (CCH) ¶98, 619 (March 29, 1982); *Untermeyer* v. *Fidelity Daily Income Trust,* 580 F.2d 22 (1978); *Heit* v. *Baird,* 567 F.2d 1157 (1977); *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1973). But the rationale of those cases is not that the directors are able to preclude suit entirely by refusing a demand. Rather, they rest on the proposition that directors, despite being defendants, are still capable of making an honest decision about whether to sue on the corporation's behalf. *See Galef* v. *Alexander,* 615 F.2d at 59. Failure to make demand only temporarily bars the shareholder's suit. Whether the directors correctly assessed the merits of the corporate claim in refusing plaintiff's demand relates to plaintiff's standing to sue, not to whether intracorporate remedies have been exhausted. Note, 44 U.Chi.L.Rev. at 181.

The business judgment rule, on the other hand, may permanently cut off the plaintiff. It determined the extent to which the directors' response to a demand should be binding on the court. The rule originated as a means of limiting liability of corporate officers and directors for mere mistakes or judgment errors so as to give them the latitude they need to run a corporation; courts will not second-guess their decisions if made honestly, in good faith and in pursuit of legitimate corporate purposes. 3A Fletcher, *Cyclopedia of the Law of Private Corporations,* §1039 (perm.ed. 1935). The rule has been applied to the decision of whether to sue, itself a matter of internal corporate management. *See e.g., United Copper Securities Co.* v. *Amalgamated Copper Co.,* 244 U.S. 261, 263 (1917). Since the derivative suit is essentially two causes

of action in one—a suit against the third party wrongdoer and a second suit against the corporate directors for their failure to sue—plaintiff must first demonstrate that the directors have wrongfully declined to proceed against the wrongdoer before he can press his claim. Note, "Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit," 73 Harv.L.Rev. 746, 748 (1960). The business judgment rule can thus bar a derivative suit entirely upon a showing that the directors' refusal to sue was in good faith. *See, e.g., Abramowitz* v. *Posner*, Fed.Sec.L.Rep. (CCH) ¶98,458 (2d Cir. Feb. 9, 1982) (Directors' refusal of plaintiff's demand was within the business judgment rule and this justified termination of a derivative suit alleging violations of Rule 10b-5 under the Exchange Act.); *See also Ash* v. *International Business Machines,* 353 F.2d 491 (3d Cir. 1965).

Defendants in the instant case seek to give the trustees' response to plaintiff's demand binding effect so as to cut off his right to sue; they are thus primarily relying on the business judgment rule, not Rule 23.1. FMR apparently seeks to incorporate the business judgment rule into the demand requirement, however, by arguing that demand would be reduced to a meaningless ritual if the trustees' response was not given conclusive weight as an independent and unbiased business decision. But courts have specifically rejected that line of reasoning. For example, in *Grossman* v. *Johnson*, the First Circuit noted that whether directors' refusal to sue bars a shareholder's derivative suit under 36(b) is irrelevant to the question of whether a demand is required by 23.1; even if the refusal had no effect, demand would still give directors an opportunity to "study the problem and decide whether to accede, in whole or in part, to the complainant's views." Fed.Sec.L.Rep. (CCH) ¶98,619 at 93,071. *See also Markowitz* v. *Brody*, 90 F.R.D. 542, 560 (S.D. N.Y. 1981). The effect of the trustees' decision not to sue FMR here has nothing to do with the question of whether plaintiff has complied with the demand required under Rule 23.1. It is enough that he has brought his complaint to the attention of the trustees and that they have informed him of their decision not to institute suit on the corporation's behalf.

Defendants' motion for dismissal because of plaintiff's alleged failure to comply with Rule 23.1 is denied.

That leaves the question of whether the trustees' response to plaintiff's demand should prevent him from proceeding with his suit because it is within the business judgment rule. In support of the motion for summary judgment on that issue, defendants submit the affidavit of the chairman of the disinterested trustees. He sets forth facts concerning the deliberations by the special committee reviewing plaintiff's demand in an effort to demonstrate that the decision not to sue and the fee reductions were the products of a reasonable and good faith business judgment.[6] In opposition, plaintiff's counsel submitted his own affidavit claiming that the committee's decision was hasty and ill-considered. Without deciding the propriety of the trustee's response, I conclude that the motion for summary judgment should be denied, since even the most reasonable decision by the trustees cannot cut off the shareholder at the threshold from pressing a claim under 36(b) of the Act.

The Supreme Court decision in *Burks* v. *Lasker,* 441 U.S. 471 (1979) is controlling on this issue. In that case, the Court said that whether directors' good faith refusal to sue can prevent a shareholder from pursuing a derivative suit depends, first, on whether state law, applied as a matter of federal law, gives the directors the power to terminate such litigation and, second, whether application of state law would be inconsistent with the policies of the federal statute under which suit is brought. The Court held that a state rule allowing directors to discontinue a derivative suit challenging the corporate purchase of commercial paper would not be inconsistent with the Investment Company Act. However,

[6] The affidavit says that the committee retained independent counsel, met with plaintiff's counsel, obtained information from FMR and conducted arms-length negotiations resulting in the fee reductions. It took into account applicable legal standards and weighed various business factors before responding to plaintiff's complaint. The disinterested trustees concluded that, in part because of the cost and disruption of litigation, it would not be in the corporation's best interests to sue FMR.

the Court singled out Section 36(b) of the Act as an example of a clear congressional decision not to allow board action in and of itself to cut off derivative suits. 441 U.S. at 484. State rules allowing directors' termination of derivative suits in those cases would conflict with the provision in the Act that board action in regard to management fees "shall be given such consideration by the court as is deemed appropriate under the circumstances." 15 U.S.C. § 80a-35(b)(2).

Defendants seek to distinguish *Burks* on the grounds that the case did not involve 36(b), and that it concerned only the directors' power to terminate litigation already begun, not the effect of a refusal to institute suit upon plaintiff's prelitigation demand. First, the Court's remark about 36(b), dictum though it may be, has been taken very seriously by the lower courts, most notably the First Circuit. *See, e.g., Grossman* v *Johnson,* Fed.Sec.L.Rep. (CCH) ¶98,610 at 93,070. (In light of *Burks* v. *Lasker,* there are "very serious reasons" for concluding that disinterested directors cannot by themselves terminate a Section 36(b) suit through the good faith exercise of reasonable business judgment); *Markowitz* v. *Brody,* 90 F.R.D. at 558-559 (*Burks* made it clear that Section 36(b) actions may not be terminated by the board of directors). Second, the timing of a board's response is insignificant.

Of course, the trustees' response to plaintiff's demand here was something more than a flat refusal to sue. In that sense, this case is different from *Burks* v. *Lasker* where directors sought summary termination without giving plaintiff any relief whatsoever. Defendants argue that because the fee reductions reflect the trustees' considered business judgment, plaintiff's complaint should be dismissed.

Both the language and the legislative history of the Act do suggest judicial deference to the decisions of disinterested directors, given a special "watchdog" role in investment company operations which should not be undercut by a

court.[7] Courts have, in fact, afforded considerable weight to trustees' decisions in passing on the fairness of advisory fees. *See, e.g., Gartenberg* v. *Merrill Lynch Asset Management, Inc.* Fed. Sec.L.Rep. (CCH) ¶89,386 (S.D.N.Y. December 28, 1981); *Tannenbaum* v. *Zeller,* 552 F.2d 402 (2d Cir. 1977). However, those determinations were made after a trial. Insofar as the issue in the case is the fairness of the revised fee, not simply the conduct of the disinterested directors in deciding on the new fee schedule, it is impossible for me to decide at this early stage whether the trustees here have acted reasonably or whether FMR's fees remain excessive as plaintiff claims. Genuine issues of material fact exist in that regard, making summary judgment inappropriate.

B. Proxy Claim.

Defendants seek partial summary judgment on plaintiff's proxy fraud claim on the grounds that plaintiff has not made a demand on the trustees, and that the proxy statement is accurate. Without deciding whether demand is excused, the undisputed facts show that the proxy statement is not false or misleading.

Plaintiff's complaint says that the table of annualized rates on page 8 of the 1982 proxy statement falsely states fee revisions approved by the board of trustees following plaintiff's demand. The table appears in the section describing the proposed new contract with FMR on which the shareholders were to vote. It is identical to the table appearing in the contract itself, attached to the proxy statement as Exhibit A.

But plaintiff says that although the table may accurately reflect the terms of contract, it does not coincide with

[7] For example, the Senate Report on 36(b) says that the section is "not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors" nor is it meant to shift the responsibility for managing an investment company from the directors to the judiciary. Directors of the fund have an important role in the management fee area, and their approval of fees should by no means be ignored. S.Rep.No. 91-184, 91st Cong. 1st Sess., Reprinted in 1970 U.S. Code Cong. & Admin. News 4897, 4902-4903.

that which the trustees ratified on October 23, 1981. He points to the affidavit of FMR vice-president Richard Reilly describing the fee limitations approved by the trustees at that time. Plaintiff is comparing apples and oranges, however. The proxy statement schedule sets forth fee limitations for incremental portions of the Trust's average monthly net assets, while the table in the affidavit sets forth the effective fee rate—a rate expressed in terms of total average net assets of the Trust, not just incremental portions. The two tables are simply two different ways of saying the same thing. Moreover, the proxy statement includes the table of effective rates along with the schedule of graduated fee limitations, so it cannot be argued that pertinent information was omitted. Although the effective rate table in the proxy statement is not identical to that in the affidavits, simple arithmetic shows that the proxy statement table is the more accurate.[1] Shareholders voted on the basis of information in the proxy statement, not the affidavit. Defendants' motion for partial summary judgment on the proxy claim is granted.

s/ RYA W. ZOBEL
District Judge

Date: December 6, 1982

[1] The affidavit table contains effective rate percentages which appear to be rounded off to the nearest fraction of a decimal point.

No. 82-1200

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

DAILY INCOME FUND, INC. and REICH & TANG, INC.,
Petitioners,

—v.—

MARTIN FOX,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' BRIEF

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April 21, 1983

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Question Presented for Review

Is a shareholder's derivative action under § 36(b) of the Investment Company Act of 1940 exempt from the director demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure?

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—v.—

MARTIN FOX,

Respondent.

PETITIONERS' BRIEF

Opinions Below

The opinion of the District Court (Hon. Kevin T. Duffy) is reported at 94 F.R.D. 94 (S.D.N.Y. 1982). The opinion of the Court of Appeals is reported at 692 F.2d 250 (2d Cir. 1982).

Jurisdiction

The judgment of the Court of Appeals was entered on October 26, 1982. A petition for a writ of certiorari was filed on January 17, 1983 and granted on March 7, 1983. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

Statutes and Rules Involved

The statutes and rules involved are § 36(b) of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. § 80a-35(b), and Rule 23.1 of the Federal Rules of Civil Procedure ("Rule 23.1").

Statement of the Case

Respondent, a minority shareholder of Daily Income Fund, Inc. ("the Fund"), a money market fund, instituted a derivative action under § 36(b) of the ICA on behalf of the Fund against Reich & Tang, Inc. ("the Adviser"), the investment adviser to the Fund, for allegedly excessive advisory fees. The Fund was also named as a defendant.

The Board of Directors of the Fund consists of five individuals: three unaffiliated directors and two who are affiliated with the Adviser. Thus, a majority of the Board of Directors of the Fund is unaffiliated.[1]

No demand was made by respondent on the directors to obtain the relief he desired. Respondent simply took matters into his own hands and, without advance notice, commenced litigation, allegedly on behalf of the Fund, in violation of the director demand requirement of Rule 23.1.

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1 The unaffiliated directors are: W. Giles Mellon, Professor of Business Administration in the Graduate School of Business Administration, Rutgers University; Alan J. Patricof, head of a private investment corporation and Dr. Yung Wong, managing Director of a venture capital investment firm. The affiliated directors are: Joseph H. Reich, President and Treasurer of the Fund, and Oscar L. Tang, Chairman of the Board and Secretary of the Fund.

The Fund promptly moved to dismiss the action for failure by respondent to comply with the director demand requirement of Rule 23.1, and that motion was granted by the District Court (11-22a). The District Court reasoned, based on a thorough review of the legislative history of the ICA, that ". . . under the statutory mandate the board of directors of an investment company is to be the first line of defense for the individual investor against any self dealing into which an adviser might be tempted." (15a). The District Court therefore held that ". . . a Rule 23.1 demand is a *sine qua non* in this type of litigation." (15a).

On appeal, the Court of Appeals reversed, holding that the director demand requirement of Rule 23.1 does not apply to a shareholder's action under § 36(b) (23-49a). The Court reasoned that a § 36(b) action is not "strictly speaking" derivative because an investment company does not itself possess the right to bring an action against its adviser for return of allegedly excess fees (28-46a). The Court of Appeals also reasoned that the director demand requirement is inconsistent with the operation of § 36(b) (46-48a).

Summary of Argument

The Court of Appeals erred in holding that a shareholder's derivative action under § 36(b) of the ICA is exempt from the director demand requirement of Rule 23.1.

The language and legislative history of § 36(b) demonstrate that a shareholder's derivative action brought thereunder must satisfy the director demand requirement of Rule 23.1. Indeed, to allow a shareholder to bypass the

board of directors of an investment company and bring a § 36(b) action, without consultation, would undermine the oversight role of the directors by denying them the opportunity to resolve the shareholder's grievance without litigation.

The Court of Appeals, however, held that Rule 23.1 does not apply to a shareholder's derivative action under § 36(b) because investment companies do not, themselves, have a right of action under § 36(b) and a shareholder's action is therefore not "strictly speaking" derivative. Both premises of that holding are incorrect—an investment company does have a right of action under § 36(b), and, even if it did not, a shareholder's action to recover allegedly excessive advisory fees is, in any event, derivative because it is brought on behalf of the company. Accordingly, Rule 23.1 applies to such an action.

The Court of Appeals also erred in holding that application of the director demand requirement to a shareholder's derivative action under § 36(b) would conflict with the operation of § 36(b). Neither the possible limitations on the ability of the directors to cut off a § 36(b) action nor the one-year limitation on recovery is inconsistent with the application of the director demand requirement to § 36(b) actions.

The result reached by the Court of Appeals ignores the important role envisioned by Congress for directors and permits institution of unchecked litigation that may well be contrary to the best interests of all the shareholders of an investment company—as such, it cannot be reconciled with the logic of this Court's opinion in *Burks* v. *Lasker*, 441 U.S. 471 (1979).

Point I

A shareholder's derivative action under § 36(b) of the Investment Company Act of 1940 is not exempt from the director demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure.

The language of § 36(b) itself demonstrates that a shareholder's action thereunder is derivative and, accordingly, a shareholder plaintiff must satisfy the director demand requirement of Rule 23.1.

§ 36(b) states, in pertinent part, that "[a]n action may be brought under this subsection . . . by a security holder of such registered investment company *on behalf of* such company. . ." (emphasis supplied). Such an action is, by definition, a derivative action. In *Burks* v. *Lasker,* 441 U.S. 471, 477 (1979), this Court stated: "A derivative suit is brought by shareholders to enforce a claim *on behalf of* the corporation." (emphasis supplied).[2] Indeed, this Court went on, in *Burks,* to refer specifically to § 36(b) actions as "derivative." 441 U.S. at 484. Accordingly, the director demand requirement of Rule 23.1 applies to § 36(b) actions, as it does to all other derivative actions in the federal courts.

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2 The Court of Appeals erroneously held that the "on behalf of" language in § 36(b) does not make a shareholder's action thereunder derivative, "but rather constitutes individual security holders as 'private attorneys general' to assist in the enforcement of a duty imposed by the statute on investment advisers." *Fox* v. *Reich & Tang, Inc., supra,* 692 F.2d at 255. No citation of authority whatsoever is offered by the Court of Appeals for this novel conclusion, and it conflicts with this Court's view in *Burks*, quoted above, that an action brought by a shareholder on behalf of a corporation is a derivative action.

The legislative history of § 36(b) confirms that Congress did not intend to exempt such actions from the scope of Rule 23.1. To the contrary, the legislative history, as interpreted by this Court in *Burks,* clearly shows that Congress, in the 1970 amendments to the ICA, intended to further the policies of corporate self-governance and the exhaustion of intracorporate remedies, both of which underlie the director demand requirement of Rule 23.1.[3]

The Senate Report, which is the basic document in the legislative history of § 36(b), states:

> "These provisions highlight the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary."

S. Rep. No. 184, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. & Admin. News 4897, 4902-03.

3 The Court of Appeals dwelt at length on the fact that the legislative history of the 1970 amendments also showed concern with the prior ineffectiveness of the independent directors with respect to advisory fees and the need for increasing the role of courts in this area. *Fox* v. *Reich & Tang, Inc., supra,* 692 F.2d at 256-61. However, as the Court of Appeals for the First Circuit held in *Grossman* v. *Johnson,* 674 F.2d 115, 122 (1st Cir.), *cert. denied,* ___ U.S. ___, 103 S.Ct. 85 (1982), "these themes are all fully consistent with the continued operation of the demand part of Rule 23.1, which would not impede or contradict any of the stated purposes."

Thus, as this Court recognized in *Burks* v. *Lasker, supra,* 441 U.S. at 484-85:

> "In short, the structure and purpose of the ICA indicate that Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds' shareholders." (footnote omitted)

Allowing a shareholder to bypass the board of directors and bring a § 36(b) action without even making a demand upon the directors is inconsistent with that purpose. The Court of Appeals for the Third Circuit stated in *Weiss* v. *Temporary Investment Fund, Inc.*, 692 F.2d 928, 942 (3d Cir. 1982):

> "The ICA and its amendments were designed to erase potential conflicts of interest inherent in the structure of investment companies by placing the unaffiliated directors in a substantial management role and providing them with authority to act as checks on advisory fees. Congress explicitly empowered the directors to redress challenges to advisory fees by imposing on directors a duty to evaluate the advisory fees and by authorizing them to terminate investment adviser contracts without penalty upon the giving of sixty days notice. 15 U.S.C. § 80a-15(a)(3) (1976). To allow shareholders to bypass the directors would undermine the role shaped for directors by the ICA." (footnote omitted).

See also *Fox* v. *Reich & Tang, Inc., supra,* 94 F.R.D. at 97; *Lerman* v. *ITB Management Corp.*, 58 F.R.D. 153, 158 (D. Mass. 1973).

Moreover, the legislative history of the 1970 amendments also demonstrates a concern to discourage unjusti-

fied derivative actions and to do so specifically through the application of the Federal Rules of Civil Procedure. In response to a question as to whether permitting a shareholder to challenge advisory fee contracts would lead to unfounded litigation, SEC Chairman Hamer H. Budge responded as follows:

> "We do not believe that this would leave the door wide open to nuisance actions. As we have pointed out previously, there are adequate safeguards under the Federal Rules of Civil Procedures [sic] and under this bill to prevent unjustified shareholder litigation."

Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. at 201 (1969). Later in his testimony, Mr. Budge again stated that the problem of "strike suits" could be adequately dealt with by the Federal Rules of Civil Procedure:

> "There are already in H.R. 11995 and in the FRCP[12] sufficient safeguards against frivolous or harassing lawsuits.
>
> 12 See e.g., Rule 23 FRCP."[4]

Id. at 860.

In sum, as the Court of Appeals for the Third Circuit concluded in *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 938:

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4 Although the citation in Mr. Budge's testimony is to Rule 23, he seems clearly to have intended to refer to Rule 23.1. *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 938; *Grossman* v. *Johnson*, *supra*, 674 F.2d at 122.

> ". . . the legislative history reflects an implicit understanding that Rule 23.1 would apply—an understanding which comports with the purposes of section 36(b)."

See also *Grossman v. Johnson, supra,* 674 F.2d at 122.

Point II

The Court of Appeals erred in holding that a shareholder's action under § 36(b) is not a derivative action.

At the heart of the decision of the Court of Appeals is its holding that a shareholder's action under § 36(b) is not "strictly speaking"[5] derivative—and thus Rule 23.1 does not apply—because an investment company does not itself possess the right to bring an action against its adviser for return of allegedly excessive fees. There are two errors in that holding: first, an investment company does have an implied right of action under § 36(b); and second, even if it does not, a shareholder's action is nevertheless derivative and, accordingly, Rule 23.1 applies to such an action.

A. An investment company has an implied right of action under § 36(b)

The holding of the Court of Appeals that an investment company cannot sue its adviser to recover allegedly excessive fees ignores this Court's decisions as to the applicable framework for determining whether a statute creates an

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[5] The Court of Appeals, in order to support its result, erroneously conjured up a new form of shareholder's action, one that both is and is not derivative. This construct is unsupported in law and renders the entire analysis of the Court of Appeals faulty.

implied right of action and misreads the legislative history of § 36(b).

In *Cort* v. *Ash*, 422 U.S. 66, 78 (1975), this Court set forth the four factors that should be considered on the issue of a statutory implied right of action. All of these factors favor recognition of a right of action under § 36(b) in an investment company.

First, it is clear that § 36(b) was enacted for the benefit of investment companies. The fiduciary duty imposed on advisers is owed to the company itself, S. Rep. No. 184, *supra*, 1970 U.S. Code Cong. & Admin. News at 4902, and any recovery obtained in a § 36(b) action will go to the investment company rather then the plaintiff.

Second, such evidence of legislative intent as there is favors recognition of the right of an investment company to bring a § 36(b) action. At the time of the 1970 amendments to the ICA, it was well established that an action by a shareholder of an investment company for breach of fiduciary duty was derivative. The common law predecessor to a § 36(b) action was a shareholder's action against the adviser for "corporate waste," which was derivative. E.g., *Smith* v. *Sperling*, 354 U.S. 91 (1957); *Saxe* v. *Brady*, 184 A.2d 602 (Del. Ch. 1962); 13 W. Fletcher, Cyclopedia of the Law of Private Corporations ¶¶ 5924, 5926-27 (rev. perm. ed. 1980). Similarly, a shareholder's implied right of action under former § 36 of the ICA (now § 36(a)) to recover excessive advisory fees was uniformly held to be derivative. E.g. *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971); *Kauffman* v. *Dreyfus Fund, Inc.*, 434 F.2d 727, 732-33 (3rd Cir. 1970); *Brown* v. *Bullock*, 194 F. Supp. 207, 245 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

In light of this background, Congress can and should be presumed to have known in 1970 that an investment company had its own right of action against its adviser. *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353, 102 S. Ct. 1825, 1841 n. 66 (1982). Since there is no evidence whatsoever that Congress intended to abolish this pre-existing right of an investment company to bring an action to recover excessive advisory fees, the Court of Appeals erred in holding that an investment company has no right of action under § 36(b). See *Herman & MacLean* v. *Huddleston*, ____ U.S. ____, 103 S.Ct. 683, 689 (1983); *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran, supra*, 102 S. Ct. at 1839; *Cannon* v. *University of Chicago*, 441 U.S. 677, 695-99 (1979).

Even if the state of law at the time of the 1970 amendments to the ICA were not conclusive, Congress' silence would still favor recognition of an implied right of action in an investment company under § 36(b). As this Court recognized in *Cannon* v. *University of Chicago, supra*, 441 U.S. at 694:

> ". . . the legislative history of a statute that does not expressly create or deny a private remedy will typically be silent or ambiguous on the question. Therefore, in situations such as the present one 'in which it is clear that federal law has granted a class of persons certain rights, it is not necessary to show an intention to *create* a private cause of action, although an explicit purpose to *deny* such cause of action would be controlling.' *Cort*, 422 U.S. at 82, 45 L. Ed. 2d 26, 95 S. Ct. 2080 (emphasis in original)."

Since § 36(b) clearly grants to investment companies the right *not* to be charged excessive advisory fees, it is not necessary, in order for this Court to recognize the exist-

ence of a right of action under § 36(b) in an investment company, to show a clear Congressional intent to *create* such a right of action; it is sufficient that there is no evidence of Congressional intent to *deny* such a right of action. The Court of Appeals therefore erred in construing Congress' silence as evidence against an investment company's right of action under § 36(b).

Third, an investment company's right to bring a § 36(b) action accords with the purposes of the ICA by providing another remedy for the recovery of excessive advisory fees and by allowing the directors of the investment company to perform their role as "watchdogs."

Fourth, since § 36(b) has already federalized this type of litigation, the implication of a right of action in an investment company would not intrude on an area traditionally relegated to state law.

The Court of Appeals for the Third Circuit analyzed the *Cort* factors at length in *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 935-36, and concluded (as we have just argued) that an investment company has a right of action against its adviser for a breach of the fiduciary duty imposed by § 36(b). See also *Grossman* v. *Johnson, supra,* 674 F.2d at 120; *Markowitz* v. *Brody,* 90 F.R.D. 542, 557 n. 12 (S.D.N.Y. 1981).

By contrast, the Court of Appeals in this case did not specifically evaluate any of these factors. Although it recognized that the legislative history of § 36(b) was silent as to whether an investment company could bring an action to recover excessive advisory fees, it construed that silence as militating against an implied right of action. Its rationale for that conclusion was that "[t]he relationship of a fund to its adviser makes it part of the problem in a

way that precludes it from being part of the solution, at least at the litigation stage." *Fox* v. *Reich & Tang, Inc.*, *supra*, 692 F.2d at 260. That conclusion is based upon a presumption of directorial hostility to § 36(b) actions. Such a presumption conflicts with the statutory scheme of the ICA and this Court's decision in *Burks* v. *Lasker*, *supra*, 441 U.S. at 482-85. As this Court stated in *Burks*, 441 U.S. at 485 n.15:

> "While lack of impartiality may or may not be true as a matter of fact in individual cases, it is not a conclusion of law required by the Investment Company Act. Congress surely would not have entrusted such critical functions as approval of advisory contracts and selection of accountants to the statutorily disinterested directors had it shared the Court of Appeals' view that such directors could never be 'disinterested' where their codirectors or investment advisers were concerned."

To deny the directors an opportunity to consider a shareholder's claim of excessive advisory fees would undercut the whole Congressional effort to enhance the role of unaffiliated directors. Although *Burks* dealt with a different ultimate issue, it aptly appraised the role Congress assigned to the unaffiliated directors in the 1970 amendments to the ICA:

> "Indeed, it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholders interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled." (footnote omitted)

Burks v. *Lasker*, *supra*, 441 U.S. at 485. Thus, an implied corporate right of action under § 36(b) is not at all

inconsistent with the purpose of the ICA. To the contrary, it furthers the role of the directors as "watchdogs" and provides another means (in addition to suits by the SEC and shareholders) to police advisory fees.

B. Even if an investment company does not have a right of action under § 36(b), a shareholder's action is nevertheless derivative and must satisfy the director demand requirement of Rule 23.1

Even if (contrary to our analysis) an investment company does not itself have a right of action under § 36(b), a shareholder's action under § 36(b) is nevertheless derivative and must be preceded by a director demand.

Since a shareholder's action under § 36(b) is brought "on behalf of" the investment company and any recovery goes to the investment company, not the plaintiff, a shareholder's action under § 36(b) is necessarily derivative. *Burks* v. *Lasker, supra*, 441 U.S. at 484.[6]

The Court of Appeals, notwithstanding this authority, held that Rule 23.1 "applies only when the specified entity has an opportunity to assert, in a court, the same action under the same rule of law on which the plaintiff share-

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6 It is also noteworthy that the lower courts have routinely treated a shareholder's action under § 36(b) as derivative in other respects as well by requiring court approval of a proposed settlement, by awarding attorney's fees to successful plaintiffs out of the amount recovered on behalf of an investment company, and by treating a settlement of a shareholder's § 36(b) action as precluding any other actions by shareholders challenging the same advisory fee. *E.g.*, *Markowitz* v. *Money-market Assets, Inc.*, [1981-1982] CCH Fed.Sec.L.Rep. ¶ 98,360 (S.D.N.Y. 1981); *Krasner* v. *Dreyfus Corp.*, 500 F. Supp. 36 (S.D.N.Y. 1980), 90 F.R.D. 665 (S.D.N.Y. 1981); *Lerner* v. *Reserve Management Co.*, [1981] CCH Fed.Sec.L.Rep. ¶ 98,036 (S.D.N.Y. 1981).

holder relies." *Fox* v. *Reich & Tang, Inc., supra,* 692 F.2d at 254. That holding finds no support in the language of Rule 23.1 which requires director demand in a derivative action brought by a shareholder "to enforce a right of a corporation . . . , the corporation . . . having failed to enforce a right which may properly be asserted by it. . . ." Thus, by its terms, Rule 23.1 applies whenever a shareholder seeks to enforce a right of a corporation which the corporation could assert; it does not require that the corporation's right must give rise to the same action under the same rule of law on which the shareholder relies.

In support of its restrictive interpretation of Rule 23.1, the Court of Appeals relied on this Court's reference in *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R. Co.*, 213 U.S. 435, 447 (1909) to a derivative action as one "founded on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff." That language is inapposite.

In *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R. Co., supra,* this Court did not purport to define a derivative action; it merely set forth one of the prerequisites to the maintenance of an action by a shareholder in the name of the corporation—i.e. that the corporation have a right of action of its own. Nor did this Court state in *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R. Co., supra* that in order for an action to be derivative, the corporation's right of action and the rule of law on which it is based must be identical to those upon which the shareholder relies. And in *Ross* v. *Bernhard,* 396 U.S. 531, 534 (1970), this Court stated merely that one of the prerequisites for a shareholder's action "was a valid claim on which the corporation could have sued. . . ."

Quite apart from the issue of whether an investment company can sue under § 36(b), it has a valid claim

against its investment adviser to recover excessive fees and can enforce that claim by means of an action under state law. See, e.g., *Llewellyn* v. *Queen City Dairy, Inc.*, 48 A.2d 322, 326 (Md. 1946).

Moreover, the purposes of the director demand requirement of Rule 23.1 are applicable to a shareholder's action under § 36(b) regardless of whether the investment company can itself bring such an action. Over 100 years ago in *Hawes* v. *Oakland*, 104 U.S. 450, 460-61 (1882),[7] this Court recognized that:

> ". . . before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the Court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances or action in conformity with his wishes."

By providing a corporation with an opportunity to "vindicate its own rights," *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541, 548 (1949), the director demand requirement serves several important purposes. The director demand requirement "furthers a principle basic to corporate organization, that the management of the corporation be entrusted to its board of directors." Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171

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7 During the same term this Court adopted Equity Rule 94 to implement that decision. The director demand requirement was later embodied in Equity Rule 27 and was incorporated in Rule 23(b) and then Rule 23.1 of the Federal Rules of Civil Procedure.

(1976). As the Court stated in *Heit* v. *Baird*, 567 F.2d 1157, 1162 n. 6 (1st Cir. 1977):

> "The purpose of the demand requirement is, of course, to require resort to the body legally charged with conduct of the company's affairs before licensing suit in the company's name by persons not so charged. Given the expense of litigation, and the normal presumption running in favor by those acting for the company, this seems only reasonable."

In addition, the director demand requirement performs several practical functions. It "enables corporate management to pursue alternative remedies, thus often ending unnecessary litigation." *Cramer* v. *General Telephone & Electronics Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129 (1979). It also serves "to afford corporate directors reasonable protection from harassment by litigious dissident shareholders, and thus to discourage strike suits by shareholders making reckless charges for personal gain rather than corporate benefit." *Markowitz* v. *Brody, supra*, 90 F.R.D. at 561. And by requiring exhaustion of intracorporate remedies, the director demand requirement serves to "foster amicable resolution of differences." *Lerman* v. *ITB Management Corp., supra*, 58 F.R.D. at 157-58.

As was well summarized in *Mills* v. *Esmark Inc.*, 91 F.R.D. 70, 72 (N.D. Ill. 1981):

> "The purpose of the demand requirement of Rule 23.1 is to allow a corporation to activate intracorporate remedies to address shareholder complaints prior to resorting to judicial intervention. . . . In theory, this salutary policy inures to the benefit of all involved. The dissident shareholder is provided with

> an opportunity to achieve his goal without incurring the expense of litigation; the directors of the corporation are allowed to occupy their status as managers of the corporation's affairs; the corporation is left to clean its own house, free from judicial entanglements; and the courts are relieved of the burden of prematurely resolving intracorporate disputes. Of course, it is also possible, indeed likely, that the corporation will refuse to take the action demanded by the shareholder. The purpose of Rule 23.1, however, is to give the corporation a fair opportunity to act on the demand, short of litigation." (citation omitted)

These policies have particularly clear application to a shareholder's derivative action under § 36(b) because of the special oversight role in advisory fees which Congress gave to the unaffiliated directors of an investment company. To exempt § 36(b) actions from the director demand requirement of Rule 23.1 would allow a single shareholder to bypass the duly elected directors and force an investment company into expensive and time-consuming litigation. In this era of burgeoning caseloads, the director demand requirement is a particularly important protection against possibly unjustified litigation.

Faced with a timely demand, the directors can respond in a number of ways short of litigation. If the directors find the claim has merit, they can negotiate with the adviser to obtain a return of fees and/or terminate the contract if the adviser refuses. If the directors find the claim lacks merit, they might nevertheless succeed in avoiding litigation by convincing the complaining shareholder that the fees are reasonable or that litigation would adversely affect all shareholders' interests. See *Weiss* v.

Temporary Income Fund, Inc., supra, 692 F.2d at 942 n.16; *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 91 F.R.D. 524, 526 (S.D.N.Y. 1981); *Markowitz* v. *Brody, supra*, 90 F.R.D. at 560-61; *Untermeyer* v. *Fidelity Daily Income Trust*, 79 F.R.D. 36, 46 (D. Mass. 1978).

The Court of Appeals in this case gave no weight to these other remedies because of its belief that, as a practical matter, they would not be effective. *Fox* v. *Reich & Tang, Inc., supra*, 692 F.2d at 254 n. 7. That belief is unsupported and conflicts with the whole purpose of the ICA to make the unaffiliated directors the "independent watchdogs" of an investment company's interests. *Burks* v. *Lasker, supra*, 441 U.S. at 484.

In sum, the central premise of the Court of Appeals' decision is erroneous: an investment company has its own right of action under § 36(b), and even if it does not, a shareholder's action under § 36(b) is derivative and must comply with the director demand requirement of Rule 23.1.

Point III

The Court of Appeals erred in holding that the director demand requirement is inconsistent with the operation of § 36(b).

As a minor theme, the Court of Appeals in this case also held that the application of the director demand requirement to a shareholder's action under § 36(b) is inconsistent with the operation of the ICA because of (1) the possible limitations on the ability of the directors to cut off a § 36(b) action and (2) the one-year limitation to recovery under § 36(b). This holding is also erroneous.

Before turning to the particular flaws in this holding, it should be noted that it conflicts with the general presumption that Rule 23.1, like all of the Federal Rules of Civil Procedure, applies to civil actions in federal district courts unless inconsistent with a statute. See Rule 1, Federal Rules of Civil Procedure. As the Court of Appeals for the Third Circuit stated:

> "Abrogation of a rule of procedure generally is inappropriate '[i]n the absence of a direct expression by Congress of its intent to depart from the usual course of trying "all suits of a civil nature" under the Rules established for that purpose.' *Califano* v. *Yamasaki,* 442 U.S. 682, 683, 700, 99 S.Ct. 2545, 2557, 61 L.Ed.2d 176 (1979). Repugnancy of a statute to a civil rule is not to be lightly implied. Rather, 'a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible.' *Grossman* v. *Johnson, supra,* 674 F.2d at 122-23 (quoting 7 Moore's Federal Practice ¶ 86.04[4] at 86-22 (2d ed. 1980)); accord *Fox* v. *Reich & Tang, Inc.,* 94 F.R.D. 94 (S.D.N.Y. 1982), rev'd on other grounds, 692 F.2d 250 (2d Cir. 1982)."

Weiss v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 936.

As demonstrated above, the legislative history of § 36(b) provides no evidence whatsoever of a Congressional intent to exempt a shareholder's action from the director demand requirement. As the Court of Appeals for the First Circuit held in *Grossman* v. *Johnson, supra,* 674 F.2d at 121:

> ". . . there is no persuasive indication that, in adopting section 36(b) Congress wished to repeal or limit the demand provision of Rule 23.1 which has

long been a general part of our federal law of practice and procedure, governing almost all derivative actions in federal courts."

To the contrary, the evidence indicates that Congress intended to afford the directors the opportunity to fulfill their oversight role with respect to advisory fees. Eliminating the demand requirement would be inconsistent with this legislative intent. Neither the possible limitations on the ability of the directors to cut off a § 36(b) action nor the one-year limitation on recovery of damages compels a contrary conclusion.

A. The possible limitations on the ability of the directors to cut off a § 36(b) action do not make the director demand requirement inapplicable.

In *Burks* v. *Lasker, supra,* 441 U.S. at 484, this Court, in dictum, suggested that § 36(b) deprives the directors of their authority to cut off a shareholder's action thereunder.[8] Based on that suggestion, the Court of Appeals below held that the traditional reason for the demand requirement does not apply—i.e., if the directors are considered too "interested" to be permitted to cut off a § 36 action, they must also be considered so "interested" as to make a demand futile. *Fox* v. *Reich & Tang, Inc., supra,* 692 F.2d at 261 & n. 13;[9] see also *Weiss* v.

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8 The ability or inability of directors to cut off (i.e. prevent or terminate) a § 36(b) action remains an open question that need not be decided by this Court to resolve the issue posed by this case.

9 In concluding that the traditional reasons for director demand do not apply in § 36(b) actions, the Court of Appeals also relied on the fact that "shareholder plaintiffs are necessarily challenging fees the directors evaluated and approved . . ."

Temporary Investment Fund, Inc., supra, 692 F.2d at 945-46, 952-53 (dissenting opinion of Gibbons, J.).

This conclusion is based on an overly narrow view of the function of the director demand requirement. That requirement is not merely a procedural advice for implementing the business judgment rule; rather as demonstrated above, it is based on a policy favoring exhaustion of intracorporate remedies which has vitality even if the directors cannot cut off a § 36(b) action. As the Court of Appeals for the First Circuit held in *Grossman* v. *Johnson, supra,* 674 F.2d at 121:

> "Nevertheless, even on that interpretation of the statute [i.e. that the directors cannot cut off shareholder's action under § 36(b)], a demand would not be futile. It would give the independent directors the opportunity to study the problem and decide whether to accede, in whole or in part, to the complainant's views. When it added § 36(b), Congress also deliberately strengthened the position of independent directors, including their dealing with advisory fees. See *Burks* v. *Lasker, supra,* 441 U.S. at 482-485, 99 S.Ct. at 1839, 1840-1941. They were not designed to be ciphers or to be overlooked. Although the court would decide for itself (on the view we accept *ar-*

Fox v. *Reich & Tang, Inc., supra,* 692 F.2d at 261. Such reliance is misplaced since, as the Court of Appeals for the Second Circuit has recognized in a more recent decision, mere approval of a transaction by the directors is insufficient to excuse demand. *Lewis* v. *Graves,* ____F.2d____, [Current] CCH Fed. Sec. L. Rep. ¶ 99,106 at 95,281 (2d Cir., Feb. 28, 1983); see also *Grossman* v. *Johnson, supra,* 674 F.2d at 124; *Lewis* v. *Curtis,* 671 F.2d 779, 785 (3d Cir.), *cert. denied,* ____U.S.____, 103 S. Ct. 176 (1982); *Greenspun* v. *Del E. Webb Corp.,* 634 F.2d 1204, 1210 (9th Cir. 1980).

guendo) the merits of the claim of excessive compensation, the independent and disinterested directors still have a substantial role. Surely, their decision to side with the complainant (entirely or in part) would have important consequences, and even their knowledgeable disagreement with the demand might be deemed worthy by the court of grave consideration under § 36(b)(2)."

Moreover, both the Court of Appeals in this case and Judge Gibbons in his dissenting opinion in *Weiss* erred in viewing the business judgment rule and the director demand requirement as necessarily governed by the same standard so that either both must apply or neither applies. In fact, although the principle of corporate self-governance underlies both, the business judgment rule and the director demand requirement involve different considerations and their applicability is not necessarily coincidental. *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 940-42; *Heit* v. *Baird*, *supra*, 567 F.2d at 1162-63 n.6. As the American Law Institute stated in its proposed Restatement of Principles of Corporate Governance and Structure § 7.02 at 270-71 (Tent. Draft No. 1, 1982):

> "It is not inconsistent for a court to employ a strict standard with respect to the excusal of demand, but then to refuse to accept a decision by the same board of directors to seek termination of the same action. . . . As some decisions have emphasized, the focus at the demand stage should be on the issue of whether the corporation may take over the suit and either prosecute it or adopt other internal corrective measures, and not on the later question of whether a decision not to sue should be respected by the court.

At the demand stage, the possibility should not be foreclosed that a demand will induce the board to consider issues and crystalize policies which otherwise might not be given attention (e.g.,new accounting controls, revised corporate policy statements or even a change in personnel or remuneration). The demand rule can have efficacy even where the board ultimately rejects the action and the court ultimately permits the plaintiff to sue."

In sum, the director demand requirement is applicable regardless of whether the directors of an investment company can cut off a § 36(b) action. Indeed, as the Court of Appeals for the Third Circuit concluded in *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 942:

> "The opportunity to resolve the shareholder grievance without resort to litigation may, in fact, be especially important if the directors are not able to terminate the suit. In that event the Rule 23.1 demand provides the only opportunity for the Fund to avert a lawsuit through internal corrective measures."

B. The one-year limitation on recovery in § 36(b) actions does not make the director demand requirement inapplicable

As a final reason for exempting § 36(b) actions from the director demand requirement, the Court of Appeals below relied on the fact that § 36(b) limits recovery to excessive fees paid up to one year before commencement of the action and that the delay caused by the directors' consideration of a demand might preclude full recovery. *Fox* v. *Reich & Tang, Inc.*, *supra*, 692 F.2d at 261-62. This contention is without merit.

The Courts of Appeals for the First and Third Circuits have well stated why the one-year limitation on recovery should have no bearing on the applicability of the director demand requirement to § 36(b) actions. In *Grossman* v. *Johnson, supra,* 674 F.2d at 122, the Court of Appeals for the First Circuit held:

> "Lastly, plaintiff invokes the short one-year limitation period on damages as sufficient reason for exempting § 36(b) cases from the demand provision of Rule 23.1—the time taken by demand-and-response before institution of an action would, it is argued, diminish the period and the amount of recovery. The truth is, however, that ordinarily the demand requirement could change the particular one-year period for which recovery was allowable but would not reduce the one-year recovery period, and probably not decrease the amount. In the unusual case in which the amount of recovery could actually be reduced by directors' dawdling or the taking of excessive time to reply to a demand, a district court could allow suit to go forward without awaiting a response. See *Mills* v. *Esmark, Inc.*, 91 F.R.D. 70, 73 (N.D. Ill. 1981)." (footnotes omitted)

Similarly, in *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 938, the Court of Appeals for the Third Circuit held:

> "We recognize that in some cases, demand will postpone the filing of suit and thereby move forward the one-year period allowed for the recovery of fees. In most instances, however, this will not reduce the allowable recovery. In any event, we do not see why demand cannot be promptly made and expeditiously considered. Notwithstanding Weiss' intimations to

> the contrary, demand is a simple procedure that is not burdensome to the shareholders. We therefore do not believe that the one-year limitation period compels the conclusion that Congress intended to eliminate the demand requirement." (footnote omitted)

Thus, there is nothing in the one-year limitation on recovery which is inconsistent with or which demonstrates a Congressional intent to exempt § 36(b) actions from compliance with the director demand requirement of Rule 23.1.

Conclusion

The judgment of the Court of Appeals should be reversed, and the Complaint should be dismissed.

Respectfully submitted,

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No. 82-1200

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

DAILY INCOME FUND, INC. and REICH & TANG, INC.,

Petitioners,

—v.—

MARTIN FOX,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENT'S BRIEF

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Question Presented for Review

Is demand upon the directors of an investment company a prerequisite to the commencement of a security holder's action for excessive compensation under § 36(b) of the Investment Company Act?

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RESPONDENT'S BRIEF

Statement of the Case

Respondent, a shareholder of Daily Income Fund, Inc. (the "Fund"), brought this action to recover excessive advisory fees paid by the Fund to its investment adviser, Reich & Tang, Inc. ("R&T"). The Fund, commonly known as a money market fund, invests in a portfolio of short-term money-market instruments such as United States Government and federal agency obligations, certificates of deposit of major banks, and prime commercial paper. For the routine services involved in selecting money-market instruments, R&T's advisory fee was set at one-half of 1% of the Fund's net assets.

During the less than three years preceding the filing of the complaint the Fund experienced a dramatic growth in

assets. As of June 30, 1978, the Fund's net assets were approximately $75 million. By April 15, 1981 they had reached a level of $775 million. Despite this tremendous increase in Fund assets, no adjustment was made in the formula by which R&T was paid for investment advice. The yearly payments to R&T thus increased from approximately $375,000 to $3,875,000. Respondent's complaint alleges that, in light of the facts under which these fees have been received, their receipt constitutes a breach of fiduciary duty under § 36(b) of the Investment Company Act (15 U.S.C. § 80a-35(b)), which authorizes shareholders to sue for excessive advisory fees.

Eight weeks after the commencement of the action, the petitioners moved to dismiss the complaint for failure to make demand upon directors. Plaintiff contended that under § 36(b) of the Act no such demand is required, but that if the court felt otherwise it should grant plaintiff leave to file an amended complaint to afford him time to make the demand and to give the directors time to make a response. The Fund, which had based its motion upon *Markowitz* v. *Brody*, 90 F.R.D. 542 (S.D.N.Y. 1981), sanctioning such a procedure, expressly acquiesced in plaintiff's request.

The district court held the motion *sub judice* for eight months and then granted it, holding that a pre-complaint demand is required. It refused to grant plaintiff leave to file an amended complaint.

The Court of Appeals for the Second Circuit reversed the district court. The Court of Appeals made a comprehensive examination of Congressional intent in enacting § 36(b) of the Investment Company Act. It found that Congress was concerned with the level of advisory fees charged to investment companies; that investment company directors had been ineffective in reducing advisory fees

and could not be expected to secure such reductions; that Congress intended to provide effective means for the courts to act; that those effective means were entrusted to shareholders and the SEC; and that consequently, Congress did not intend to create a right of action by the investment company itself.

Since the investment company does not itself have a right of action, the court held, no demand is required on the directors. The court noted that this conclusion is reinforced by this Court's statement in *Burks* v. *Lasker*, 441 U.S. 471, 484 (1979), that Congress intended in § 36(b) to prevent board action from cutting off shareholder suits. It also found support for its conclusion in the short one-year statute of limitations contained in § 36(b), which would eliminate a substantial portion of the recovery if demand procedures were required to be observed.

Summary of Argument

Congress enacted § 36(b) to control excessive advisory fees. Investment company directors had been ineffective in securing fee reductions. Congress therefore gave the power of enforcement to security holders and to the Securities and Exchange Commission.

Since the investment company itself has no right of action under § 36(b), the security holder bringing a suit for excessive compensation is not required to make a demand upon the board of directors. Moreover, even if the investment company could sue, the very wording of the statute and the intent behind it provides the fund shareholder with a right to maintain an action that cannot be obstructed by any fancied need to request action by those whose very inaction gave rise to the legislation.

ARGUMENT

POINT I

An Investment Company Has No Right of Action Under Section 36(b).

A. *The Statutory Language.*

Section 36(b) of the Investment Company Act, added in 1970, provides that any security holder of an investment company, or the Securities and Exchange Commission, may bring an action to recover damages for the investment company for excessive compensation paid to the investment company's investment adviser. The section does not create a right of action which may be brought by the investment company itself.

The uncontested starting point for determining whether the statute impliedly confers the right to sue upon the corporation is examination of the actual language utilized by Congress; *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976). Section 36(b), specifying who may bring actions for excessive compensation, designates only the Securities and Exchange Commission or a security holder of a registered investment company.

This is not, thus, the typical stockholder's derivative action. The typical action is brought where the corporation has a right, created by statute or otherwise, which the directors do not enforce. Rights which enure to corporations are created by thousands of statutes, state and federal; there is no need to expressly provide for a shareholder's derivative action, for if the directors improperly fail to pursue the corporate benefits, a shareholder may sue derivatively. Thus, when Congress creates a right of action that, by the express terms of the statute, may be asserted directly by a security holder and not by the cor-

poration, it must be presumed to intend something other than the usual means of derivative procedures for enforcement.

These considerations, pertinent to shareholder actions, coincide with broader principles enunciated by this Court to support the conclusion that the statute does not create a right of action in the corporation. This Court has consistently refused to imply rights of action where express statutory provisions for other forms of proceeding are provided by Congress. Thus, in *S.I.P.C. v. Barbour*, 421 U.S. 412, 419 (1975), the Court stated ". . . express statutory provision for one form of proceeding ordinarily implies that no other means of enforcement was intended by the Legislature." The culmination of this line of cases, of which a sampling is set forth in the margin,[1] was stated by the Court in *Middlesex County Sewerage Authority v. National Sea Clammers Association*, 453 U.S. 1, 101 S.Ct. 2615 (1981), cited approvingly by both the majority and the dissent in *Merrill Lynch Pierce Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 102 S.Ct. 1825, 1839; dissent pp. 1848, 1849, 1853 (1982). In that case, Congress had provided statutory remedies to government officials and private citizens, just as under § 36(b) Congress entrusted enforcement to the SEC and to security holders of investment companies. This Court took special note of these provisions. It stated:

> "These Acts contain unusually elaborate enforcement provisions, conferring authority to sue for this

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[1] *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979); *Cannon v. University of Chicago*, 441 U.S. 677 (1979); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979); *Universities Research Association, Inc. v. Coutu*, 450 U.S. 754 (1981); *Northwest Airlines, Inc. v. Transport Workers Union*, 451 U.S. 77 (1981); *California v. Sierra Club*, 451 U.S. 287 (1981); *Texas Industries, Inc. v. Radcliff Materials*, 451 U.S. 630 (1981).

purpose both on government officials and private citizens. . . .

In view of these elaborate enforcement provisions it cannot be assumed that Congress intended to authorize by implication additional judicial remedies . . . As we stated in *Transamerica Mortgage Advisers, supra*, 'it is an elemental canon of statutory construction that where a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it.' . . . In the absence of strong indicia of a contrary congressional intent, we are compelled to conclude that Congress provided precisely the remedies it considered appropriate." (101 S.Ct. at 2623).

Reinforcing this reading of the statute is the fact that the Investment Company Act is a comprehensive legislative scheme to regulate the operation of investment companies. In *Texas Industries, Inc. v. Radcliff Materials*, 451 U.S. 630, 101 S.Ct. 2061 (1981), this Court refused to imply a right of contribution in the Sherman Act (101 S.Ct. at 2069):

"'The presumption that a remedy was deliberately omitted from a statute is strongest when Congress has enacted a comprehensive legislative scheme including an integrated system of procedures for enforcement.' *Northwest Airlines, Inc. v. Transport Workers Union, supra*, —— U.S. —— at ——, 101 S.Ct. at 1584."

". . . There is nothing in the statute itself, in its legislative history, or in the overall regulatory scheme to suggest that Congress intended courts to have the power to alter or supplement the remedies enacted."

Section 36(b) is indeed a "comprehensive legislative scheme including an integrated system of procedures for enforcement." It creates a new cause of action for recovery of unreasonable advisory fees which obviates the necessity of proving personal misconduct on the part of any defendant. It reflects congressional dissatisfaction with the ability of investment company directors to obtain appropriate redress. It confers the power to sue on the SEC and security holders.

As recognized in *Boyko v. The Reserve Fund, Inc.*, 68 F.R.D. 692 (S.D.N.Y. 1975), ". . . nowhere in the legislative history of Section 36(b) does an action by the directors of the Fund seem to be contemplated." *Id.* at 695. In that connection, the court stated:

> "This omission was apparently not the result of Congressional oversight. The legislative history of the amendment is relatively comprehensive, and the amendments themselves were enacted in the Senate only after a three-year period of extensive committee hearings and executive sessions on the subject matter."

See also, *Blatt v. Dean Witter Reynolds Intercapital, Inc.*, 528 F.Supp. 1152, 1155 (S.D.N.Y. 1982) (". . . nor does the statute provide directors the right to institute suit . . .").

B. *The Legislative History.*

The legislative history of § 36(b) clearly demonstrates Congress' intention to vest the right to bring suit in security holders and the SEC and thereby avoid the necessity of requesting action from the board of directors. The statute was designed to provide a meaningful remedy for excessive advisory fees charged to investment companies. Those fees had grown to substantial proportions. The prevalent structure of investment companies had (and has

today) the unusual feature of external management, *i.e.*, the investment advice and management of most investment companies is provided by an organization not subject to the direct control of the board of directors.

Significant among the indications of Congress' intent to authorize security holders rather than directors to bring suit is its rejection of a bill proposed by the Investment Company Institute ("ICI") which would have vested the right to bring action in the investment company itself. When the legislation was pending before Congress the ICI proposed an amendment which, with respect to actions for excessive compensation, would have provided:

> "Such actions may be brought only *by the company* or a security holder thereof on its behalf and only in an appropriate District Court of the United States."

Hearings on S.1659 Before the Committee on Banking and Currency, United States Senate, 90th Cong. 1st Sess., p. 101 (1967) (emphasis supplied).[3] SEC Chairman Manuel F. Cohen strongly opposed the proposed ICI alternative and, while his comments were directed at numerous aspects of the ICI's proposal, he clearly stated his opposition to any alternative which would "hamstring the courts" in examining the fairness of advisory fees:

> "Thus, the industry has not provided any effective means of enforcing the standard of reasonableness. . . . We see no reason why a fiduciary who has received unreasonable fees should be allowed to retain the unreasonable portion of his fee merely because the unaffiliated directors were unable to do anything about the situation. The inability of the unaffiliated directors

[3] Hereafter "1967 Senate Hearings".

freely to exercise their business judgment and negotiate a reasonable fee is the very reason why judicial protection is necessary."

Id., p. 96.[3]

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[3] Throughout the Congressional hearings the SEC consistently took the position that the independent directors were ineffective in securing reduction of advisory fees and that court review of management fees is required to protect the interests of fund shareholders. See, for example, *id.* pp. 1193-94, 1199, 1200 (interpolation supplied; emphasis in original):

> "The plain fact which emerges from our studies and these hearings is that in a significant number of cases mutual fund advisory fees are excessive."
>
> * * * * *
>
> "The 'unaffiliated' directors have not been able to act effectively to protect the shareholders' interests in relation to the fees. In many instances, the mechanical one-half of one percent advisory fee rate set in the 1930's has not been modified appreciably."
>
> * * * * *
>
> "In the future, lawyers will make certain that prescribed rituals are followed, and that the minutes of directors meetings contain all the necessary recitals, but real bargaining and effective control of the negotiation process will still be impossible. Most fund boards presently contain a majority of unaffiliated directors—with no discernible results in the fee area."
>
> * * * * *
>
> "On balance the 'unaffiliated' or independent director provided for in the statute as a protection for public shareholders really serves as insulation for the adviser in his operation of the fund. Approval of the advisory contract by the unaffiliated directors creates an appearance of an independent 'watch-dog' over the affiliated directors. This appearance rarely reflects the reality. The few cases where independent directors have asserted themselves do not change the total picture, nor does it mean that we should be optimistic about their possible future effectiveness. Nor should this Commission view the strengthening or adding to the required number of unaffiliated directors as a reasonable alternative to the solution we have proposed in our Bill."
>
> * * * * *
>
> ***"Court Review of Management Fees is Necessary."***

Congress rejected the alternative proposed by the ICI and provided that excessive compensation actions could be brought only by the SEC or security holders.

Moreover, the legislative history overwhelmingly demonstrates Congressional intent to give effective means to security holders to take action against excessive investment advisory fees. The bill was predicated, as the Senate Committee Report states (Report of the Senate Committee on Banking and Currency No. 91-184, 91st Congress, 1st Sess. pp. 1-2), on the Securities and Exchange Commission's findings in its 1966 Report on Investment Companies. That Report, entitled "Public Policy Implications of Investment Company Growth" ("PPI") (House Report No. 2337, 89th Congress, 2d Sess.) stated:

> "It has been the Commission's experience in the administration of the Act that in general the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates in the mutual fund industry." (p. 131)
>
> * * * * *
>
> "Absent express recognition of the duty to charge reasonable fees in the area of management compensation, the means provided in the Act for the enforcement of that duty in this area are unclear and inappropriate. . . . In the Commission's views, section 36 should be broadly construed so as to effectuate the remedial purposes of the Act." (p. 143)
>
> * * * * *
>
> "The analysis of the shareholder fee litigation not only underscores the need for changes in existing statutory provisions relating to management compensation in the investment company industry, but points to the direction which these changes should take. It makes

clear the need to incorporate into the Act a clearly expressed and readily enforceable standard that would measure the fairness of compensation paid by investment companies for services furnished by those who occupy a fiduciary relationship to such companies." (p. 143)

* * * * *

"The right of the Commission as well as investment company shareholders to take action against violations of the statutory standard of reasonableness is essential to effective enforcement." (p. 146)

* * * * *

"The unaffiliated directors, as the only potentially disinterested persons in the manageemnt of most investment companies, can and should play an active role in representing the interests of shareholders not only in connection with management compensation but in other areas where the interests of the professional managers may not coincide with those of the company and its public investors. Strengthening the voice of truly disinterested directors in investment company affairs is important to the protection of public shareholders. But even a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company's adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation." (p. 148)

Congress was also aware that, in contrast to many industrial companies, in almost every case investment companies had then (and have now) a majority of unaffiliated directors. Mr. Joseph E. Welch, Chairman of the Federal Legislative Committee of the ICI, so testified:

"In actual fact, almost all of the funds have a majority of independent directors, or unaffiliated directors, on their boards. This occurs because quite often the investment manager and the underwriter are the same entity or related entities, and there is a provision in the act which requires that a majority of the fund board be unaffiliated with the fund underwriter." (1967 Senate Hearings, p. 194)

Given a majority of unaffiliated directors, the traditional excuses justifying failure to make demand would ordinarily be inapplicable in the absence of a showing of self-interest or bias. Petitioners' contentions thus imply that Congress spent three years in creating a remedy which it knew would be practically unenforceable. But, of course, it had no such intention. Congress, the SEC and even the ICI fully expected that enforcement of the constraints against excessive compensation would be by security holders and the SEC, and not by the investment company. See, *e.g.*, 1967 Senate Hearings, pp. 272-73.

Indeed, if Congress had any notions that the directors would be effective in securing relief, the SEC and many other witnesses reepatedly disabused them of the notion. As SEC Chairman Manuel F. Cohen testified:

"Senator Williams: Have the unaffiliated directors ever upset the regular directors' applecart?

Mr. Cohen: I have never heard of it in my 25-odd years in association with these funds." (Id., p. 81)

See aso Hearings Before the Senate Committee on Banking and Currency on S.34 and S.296, pp. 168-69 (1969) ("1969 Senate Hearings"); 1967 Senate Hearings, p. 710.

The Senate Committee Report left no doubt of the desirability of stockholder access to the courts (Report of

the Committee on Banking and Currency, Senate Report No. 91-184, 91st Cong., 1st Sess., p.2 (1969)):

> "In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.
>
> Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty."

And see id., pp. 6-7:

> ". . . the ultimate responsibility for the decision in determining whether the fiduciary duty has been breached rests with the court . . .
>
> * * * * *
>
> ". . . this section is designed to . . . provide a means by which the Federal Courts can effectively enforce the federally-created fiduciary duty with respect to management compensation."

The petitioners are able to point to only two aspects of the legislative history, neither of which supports their contention. First, they point to a portion of the Senate Report which indicates an intention to strengthen the role of unaffiliated directors within the corporation (Petitioners' Br., p. 6). To be sure, Congress did intend to strengthen the role of disinterested directors. But if there is any inconsistency between this intention and the provision enabling security holders to sue directly, it is one mandated by Congress. Petitioners' judicial authority for the

general proposition of directorial responsibility under the Act—*Burks* v. *Lasker,* 441 U.S. 471 (1979)—singles out § 36(b) as preventing board action from cutting off shareholder suits.

Their other reliance is placed upon two statements by SEC Chairman Budge (Chairman Cohen's successor) that the Federal Rules of Civil Procedure provide safeguards to prevent unjustified shareholder litigation. (Petitioners' Br., p. 8). Apart from the fact that the quotations from Chairman Budge are taken completely out of context,[4] the petitioners' effort to garner support from Chairman Budge's testimony is based upon an attempted alteration of his actual remarks. Chairman Budge in referring to safeguards in the Federal Rules of Civil Procedure cited as an example Rule 23.[5] Petitioners ask the Court to believe that Mr. Budge intended to refer to Rule 23.1 rather than Rule 23 and from this they ask the Court to infer that Mr. Budge had in mind the demand requirement which is a part of Rule 23.1, although it does not exist in Rule 23.

In fact, however, there is no reason to suppose that Chairman Budge intended anything other than what he said.

[4] Chairman Budge was addressing a proposal that a shareholder would have to wait six months after requesting Commission action before he could bring his own suit. He objected to the provision, noting that the Commission had taken the position that the interposition of procedural obstacles should not be applied in litigation involving allegations under the Investment Company Act. He went on to state that the spectre of shareholder actions flooding the courts with harassing law suits is a much overworked boogeyman which should not deter the Congress from passing the legislation, and that shareholder actions had played an important role in protecting shareholders from insiders who are willing to betray their company's interest in order to enrich themselves. Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, 91st Cong., 1st sess., pp. 201-2, 860 (1969) ("1969 House Hearings").

[5] Id., at p. 860.

The court below noted that a § 36(b) action is not strictly speaking a derivative action, and, although the petitioners and the ICI as *amicus* take issue with this statement, there is ample support for the Court of Appeals, and, by the same token, for Chairman Budge's view.[6]

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[6] Section 36(b) is similar to § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) in providing expressly for an action by a security holder. The courts in construing § 16(b) have noted

> "The statute here involved creates a new cause of action, which, while similar in some respects to a secondary or derivative right, is not such a right at all. It is in reality a primary right. This is so because the statute which creates it makes it so."

Dottenheim v. *Murchison*, 227 F.2d 737, 738 (5th Cir. 1955), *cert. denied*, 351 U.S. 919 (1956); see also *Benisch* v. *Cameron*, 81 F.Supp. 882, 884 (S.D.N.Y. 1948); *Pellegrino* v. *Nesbit*, 203 F.2d 463, 466 (9th Cir. 1953); *Blau* v. *Oppenheim*, 250 F.Supp. 881, 883 (S.D.N.Y. 1966); *Blau* v. *Albert*, 157 F.Supp. 816, 818 (S.D.N.Y. 1957).

Legal commentary also supports this analysis:

> "While there is a superficial similarity between Section 16(b) suits and the ordinary shareholders' derivative actions, it is indicated clearly on the face of Section 16(b) that it has a broader reach than such derivative suits in a number of important aspects. Its fundamental purpose, moreover, is to make disgorging of insiders' profits almost automatic. Hence, those limitations that have been developed in respect to derivative suits, because many of them have been found to be unmeritorious, ought not to apply in the present context . . . . The security holder plaintiff in a Section 16(b) action, in addition to seeking recovery for the benefit of all present security holders as in the ordinary derivative suit, acts as an instrument of a statutory policy against short-term insider trading. As such, a defense addressed to the fact that he may have purchased his securities to qualify as a party to the action and is not aggrieved should be unavailable. A Section 16(b) suit differs from a stockholder's derivative action in that it is founded upon a specific statute enacted to remedy an existing evil." Ruben and Feldman, Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders, 95 U. of Penn. Law Review, 468, 473, 474 (1947).

At least one commentator, the author of this brief, pointed out the similarity between § 16(b) and § 36(b) prior to the latter's

The correctness of Chairman Budge's reference to Rule 23 can be ascertained by reviewing the remarks of the advisory committee which proposed Rule 23 in 1966. The advisory committee noted that subdivision (b)(1)(B) of Rule 23 would apply "... to an action which charges a breach of trust by an indenture trustee or other fiduciary similarly affecting the members of a large class of security holders or other beneficiaries, and which requires an accounting or like measures to restore the subject of the trust." 39 F.R.D. 69, 101 (1966). And the cases relied upon by the advisory committee involve, *inter alia,* claims for excessive compensation; in short, the very prototype of a § 36(b) action. It is thus perfectly logical to assume that Chairman Budge meant what he said; that he intended to rely on Rule 23, which, of course, has no requirement for directorial demand; and that Congress so understood him.

The ICI as *amicus* contends that the legislative history of § 36(b) discloses a pervasive concern with "strike suits." (ICI Br., pp. 19-20). As we have seen before (p. 14, n.4, *supra*), most of these quotations are taken out of context. But more importantly, where there was expression of some concern about unjustified law suits, the recommended solu-

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passage; Meyer, *The Legislative Impact on Advisory Fees,* Mutual Funds, 303, 335 (PLI 1970).

See also 2 Frankel, *The Regulation of Money Managers* 282 (1978):

> "... By analogy to judicial interpretation of section 16(b) of the 1934 Act, it could be argued that rules of procedure cannot abrogate an express right of action in the Act."

The ICI contends that the legislative history describes § 36(b) as a derivative action. (ICI Br., p. 19n. 43, and accompanying text). The references in the legislative history, however, were to suits under prior law or general allusions to derivative and shareholder litigation. See, for example, the reference by Congressman Blanton to then existing actions against officers and directors; 116 Cong. Rec. 33,286 (1970).

tions did not include subjecting plaintiff shareholders to demand procedures. Thus, for example, Judge Friendly, upon whom the ICI relies, stated:

> "There remains the claim that § 15(d) [later § 36(b)] would be a litigation breeder. But it is not a valid objection that a statute may lead to the bringing of lawsuits; what would matter would be unjustified lawsuits. While some derivative actions are brought simply for harrassment, we have become increasingly aware that others serve a most useful purpose in policing directors and officials who otherwise would be laws unto themselves. Indeed we have the highest authority for this proposition. The Supreme Court has said, in a not unrelated context, that 'Private enforcement of the proxy rules' through actions by stockholders 'provides a necessary supplement to Commission action' in view of the limited resources available to the SEC, and has analogized this to the role of the private treble damage suit in the enforcement of the antitrust laws. J.I. Case Co. v. Borak, 377 U.S. 426, 432-33 (1964).
>
> "There are a good many safeguards against unjustified suits under § 15(d). First of all, the funds are given a year to bring their houses into what they conceive to be order, § 28(1). They would be well advised to reduce advisory fees at least to the level marked out by settlements in the suits brought under existing law. Funds that had not done this, particularly large ones, would be the prime targets for private actions. Although suits might be brought against others, I suspect the plaintiffs would be content to leave these on the back burner while the suits against the more vulnerable funds progressed to settlement of judgment. Once a half dozen actions had been decided by appellate courts, most funds would bring themselves info a

position where they would no longer be attractive objects for suit. I put it that way because the economies are such that private actions will not be prosecuted unless there is a strong probability of success; lawyers will not wish to spend years litigating against well-financed defendants unless there are real prospects of financial reward." 1967 Senate Hearings, pp. 1016-17 (interpolation supplied).

Of even greater importance is the action taken by the House of Representatives. The House did have some concern about unjustified law suits. However, it proposed to deal with the issue not by imposing a demand requirement, but by requiring that the shareholder be a *bona fide* shareholder acting in good faith and with justifiable cause and that he prove his case by clear and convincing evidence. Thus, the House Report, H.R. Report No. 91-1382, 91st Cong. 2d Sess. (1970), stated (pp. 7-8):

> "The new section 36(b) added by the reported bill is basically the same as that which would be added by the Senate bill with two exceptions. First, the reported bill specifically requires that the shareholder bringing an action for breach of fiduciary duty be a 'bona fide shareholder' and be 'acting in good faith and with justifiable cause.' This is intended, not as a substantive change, but as a clarification of the fact that the courts should only entertain such actions by bona fide shareholders who are acting in good faith. Secondly, the reported bill requires that the plaintiff in an action under section 36(b) shall have the burden of proving the breach of fiduciary duty by clear and convincing evidence. This increased burden of proof was added by your committee to prevent the harassment of investment advisers by ill-founded and nuisance law suits, the so-called strike suit. It is not

> intended to hamper the well-founded law suit, and it is not intended to negative the traditional concept of fiduciary duty."

The House, however, receded from its proposal and accepted the Senate version without extended comment. Conference Report, p. 30 (H. Report No. 91-1631, 91st Cong. 2d Sess. (1970)).

Notwithstanding the language of the statute and the overwhelming legislative history, both of which combine to mandate direct stockholder actions, the petitioners contend that the investment company has its own right of action under § 36(b). Such a right of action, they say, should be implied because, at the time of the 1970 Amendments to the Act, Congress knew that an investment company had its own right of action against its adviser and merely intended to continue this well-established right. (Petitioners' Br., pp. 10-12). Petitioners' principal reliance is upon *Merrill Lynch, Pierce Fenner & Smith* v. *Curran,* 456 U.S. 353, 102 S.Ct. 1825, 1839 (1982).

Curran, however, is quite to the contrary. In *Curran* this Court was asked to determine whether previously implied rights of action under the Commodity Exchange Act survived or would be rejected as a result of the 1974 amendments to that statute which had made substantial changes in the statutory scheme, including the addition of new satutory remedies, but which had left intact the provisions under which the courts had previously implied rights of action. This Court held that, since Congress was aware of the earlier judicially implied rights of action and expressed no desire to eliminate them, one could infer that by not repealing the implied rights Congress intended to retain them.

Section 36(b), on the other hand, was newly codified by the 1970 amendments. It created a totally new cause of action with carefully crafted standards and a very short statute of limitations. It imposes liability without personal misconduct. It limits recovery to the actual recipients of the excessive compenstaion. There was no previous judicial record recognizing implied rights of action under section 36(b) prior to the 1970 amendments because it did not yet exist. *Curran*, therefore, offers no assistance to this Court in discovering an implied right of action under a new section creating a limited new cause of action, and is, indeed, to the contrary.

Indeed, counsel of record for the petitioners proclaimed the uniqueness of § 36(b) to this Court in 1978. At that time he stated

> "Section 36(b) was enacted into law by Congress in 1970 as an amendment to the Investment Company Act of 1940—it is a unique and highly specific section dealing solely with the compensation of investment advisers. Section 36(b) *expressly* created a right of action by a shareholder of a mutual fund against the investment adviser for breach of fiduciary duty with respect to investment advisory fees, irrespective of whether the disinterested directors have, in the exercise of their business judgment, approved those fees.
>
> * * * * *
>
> "In short, the subject of investment adviser compensation covered by Section 36(b) is *sui generis*."

Petitioners' Brief in *Burks* v. *Lasker*, No. 77-1724, pp. 27-28 (emphasis in original).

Section 36(b) is thus not, as petitioners contend, an extension of the shareholders' common law action for cor-

porate waste (Petitioners' Br., p. 10). Nor does the Fund, as the ICI contends (ICI Br., p. 14), have an identical cause of action under Maryland law for excessive advisory fees, which, according to the ICI, the Fund is not precluded from asserting. Section 36(b) constitutes the exclusive remedy against an investment adviser for excessive advisory compensation; not involving personal misconduct; *Fogel* v. *Chestnutt*, 668 F.2d 100, 112 (2d Cir. 1981), *cert. denied*, —— U.S. ——, 103 S.Ct. 65 (1982); *Halligan* v. *Standard & Poor's/Intercapital, Inc.*, 434 F. Supp. 1082, 1084 (E.D.N.Y. 1977); and Subdivision 5 of § 36(b) requires that the action be brought in a federal district court.[7]

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[7] Implied rights of action under the Act were recognized by the courts before the 1970 amendments under previously enacted sections of the Act prohibiting waste, conversion, gross misconduct, etc. (*Esplin* v. *Hirschi*, 402 F.2d 94 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969); *Levitt* v. *Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Taussig* v. *Wellington Fund, Inc.*, 313 F.2d 472 (3d Cir.), *cert. denied*, 374 U.S. 806 (1963); *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961). Such implied rights of action were found under sections 15, old 36 (which became 36(a) in the 1970 amendments), 37 and 48, in light of *Curran*, would appear to continue with the same vitality after the 1970 amendments. *Fogel* v. *Chestnutt*, *supra*; *Jerozal* v. *Cash Reserve Management, Inc.*, Fed.Sec.L.Rep. (CCH) ¶ 99,019 (S.D.N.Y. Aug. 10, 1982). The existence of these implied rights of action before the 1970 amendments should not, however, cause the courts to imply a new right of action under section 36(b).

POINT II

Under Section 36(b) of the Investment Company Act Demand Upon Directors to Institute the Action Is Not Required.

In the previous Point we have shown that an investment company does not have a right of action under § 36(b). Since it has no right of action, demand upon the directors to institute such an action is required neither by Rule 23.1 F.R.C.P. nor by the dictates of common sense. Moreover, even if the investment company did have a right of action, the statutory specification of security holders as persons entitled to bring such actions obviates whatever necessity might otherwise exist for requesting action by the directors.

A. *The Absence of a Right of a Corporation to Sue Renders Inapplicable Any Requirement to Make a Demand on the Directors.*

By its terms Rule 23.1 F.R.C.P. applies only to those situations where a corporation fails "to enforce a right which may properly be asserted by it." The inapplicability of the demand requirement where the corporation is powerless to bring suit is so manifestly self-evident that it cannot seriously be questioned. But the Petitioners do.

Petitioners' first argument is that, even without a claim under § 36(b), the corporation has a valid claim under state law against its investment adviser to recover excessive fees. (Petitioners' Br., pp. 15-16). As we have shown above, however (p. 21), § 36(b) is the exclusive remedy for recovering excessive advisory fees. The prescription of the explicit and detailed federal standard necessarily requires uniform federal interpretation, *Burks* v. *Lasker*, 441 U.S. 471, 479 n.6 (1979), and preempts the field; *DeRenzis* v. *Levy*, 297 F.Supp. 998 (S.D.N.Y. 1969).

Of course, even if the investment company had an action for corporate waste under the common law, this would hardly justify a demand requirement in a § 36(b) action. Under § 36(b) a shareholder is entitled to recover on behalf of the company if he can prove a breach of fiduciary duty with respect to the receipt of advisory fees. He is not required to prove personal misconduct, and it would be a subversion of the purpose of the Act to relegate him to forego the standards of § 36(b) and await the outcome of an action for common law waste of assets. It was precisely because Congress "decided that the standard of 'corporate waste' is unduly restrictive and recommends that it be changed" that § 36(b) was enacted; Report of the Senate Committee on Banking and Currency to Accompany S. 2224, S. Rep. No. 91-184, 91st Cong. 1st sess., p. 5 (1969).

Petitioners contend that demand is useful because it gives the directors an opportunity to obtain redress short of litigation. However, Congress in enacting § 36(b) did so in large part because it felt that directorial action was ineffective in the investment company sphere:

> "Because of the uniqne structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arms-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the

American economy." Sen. Rep. No. 91-184, 91st Cong., 1st Sess., p. 5 (1969).

The court below dealt squarely with the Petitioners' contentions:

"As indicated, we disagree that availability of informal methods of attempting to recoup excessive adviser fees is sufficient to trigger the demand requirement of Rule 23.1. Moreover, we find the examples given by the Fund—negotiating with the Adviser to obtain a refund, and terminating the contract, Brief for Defendant-Appellee Daily Income Fund, Inc. at 5-6—not persuasive. Negotiations may well fail, and termination of the contract, although perhaps depriving the adviser of future business, may not effect the remedy sought by the shareholder plaintiff, which is the return of excessive fees. Additionally, 'a mutual fund cannot, as a practical matter sever its relationship with [its] adviser.' S.Rep. 184, 91st Cong., 1st Sess. 5 1969), *reprinted in* 1970 U.S. Code Cong. & Ad. News at 4901. Moreover, given the directors' past relationship with the adviser in approving the contract in the first place, 15 U.S.C. § 80a-15(c), the likelihood that negotiations will prove effective is highly speculative. *See Blatt v. Dean Witter Reynolds Intercapital, Inc., supra,* 528 F.Supp. at 1156 (dictum). In reaching this conclusion, we do not ignore the salutary purpose served by requiring complaining shareholders to first 'activate intracorporate remedies,' *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D.Ill. 1981). Rather we conclude that a demand will not be mandated unless, should intracorporate efforts prove insufficient, the corporation itself may bring suit. *Id.* (quoting *Hawes v. Oakland*, 104 U.S. 450, 460-61, 26 L.Ed. 827 (1882))."

F.2d at 254 n.7.

Moreover, imposing a demand requirement for the sole purpose of triggering internal corporate mechanisms, no matter how salutary they may be thought to be, would effectively convert a rule of litigation procedure to a substantive requirement. As such, it would run afoul of the Enabling Act, 28 U.S.C. § 2072. Petitioners contend, relying on *Grossman* v. *Johnson*, 674 F.2d 115 (1st Cir.), *cert. denied*, —— U.S. ——, 103 S.Ct. 85 (1982), and *Weiss* v. *Temporary Investment Fund, Inc.*, 692 F.2d 928 (3d Cir. 1982) (petition for cert. pending), that § 36(b) should be harmonized with Rule 23.1 of the Federal Rules of Civil Procedure. However, where a federal rule of civil procedure conflicts with a federal statute it is the rule, not the statute, which must yield; 28 U.S.C. § 2072.

B. *Even if the Corporation Had a Right of Action Under § 36(b), Plaintiff Would Not Be Required to Make a Demand.*

This Court has already considered the Congressional intention in enacting § 36(b) and has held that under that section a security holder's action may not be terminated by a court simply because a board of directors or a committee thereof urge it to do so; *Burks* v. *Lasker*, 441 U.S. 471, 484 (1979):

> ". . . And when Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b), 84 Stat. 1428, 15 U.S.C. § 80a-35(b)(2), added to the Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to advisor's fees. No similar provision exists for derivative suits of the kind involved in this case." (Footnotes omitted)

The ICI denigrates this Court's statement in *Burks* by referring to it as *dictum* and by criticizing the court's re-

liance on § 36(b)(2), (ICI Br., p. 24n.48). This Court will be the own judge of the importance which it wishes to attach to its prior statements. We think the statement was not *dictum* because it formed an integral part of the rationale. If it be regarded as *dictum*, it is nonetheless carefully considered *dictum*.

The Court's reliance in *Burks* on § 36(b)(2), which instructs the courts to consider the approval given by the directors of a fund to advisory fee compensation, is quite appropriate. The Senate Committee noted that implicit in the requirement to evaluate directorial consideration was the fact that "such consideration would not be controlling in determining whether or not the fee encompassed a breach of fiduciary duty." S.Rep. No. 91-184, 91st Cong., 1st Sess., p. 15 (1969). If the directors are unable to make dispositive determinations, a demand upon them is otiose. Thus, § 36(b)(2), as well as § 36(b), compels the conclusion that no demand is required.

The petitioners rely on the holdings in *Grossman* v. *Johnson, supra,* and *Weiss* v. *Temporary Investment Fund, Inc., supra.* But those decisions are weak tea indeed. The First Circuit in *Grossman* acknowledged that a demand requirement in a § 36(b) action "may tend toward the status of a legal vermiform appendix", 674 F.2d at 123, and both cases claimed to divine a difference between terminating litigation and preventing its commencement.

However, there is no logical justification for treating termination of an action differently than the demand requirement. When this Court said that Congress intended "to prevent board action from cutting off derivative suits", it based its holding on a statute which simply provides that a security holder can bring an action. The statute itself refers neither to demand nor to termination. However, the strong implication of the statute and its legis-

lative history is that Congress intended to permit plaintiff shareholders to by-pass the board of directors because mutual fund directors could not be trusted to make an objective decision concerning compensation.

The purpose of a demand is to enable the board of directors to exercise their business judgment. Where, as here, Congress has concluded that directorial judgment is not determinative, a demand is not required. The petitioners' contention that a shareholder must await the outcome of the directors' deliberations is in direct conflict with Congress' findings that "the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates" [8] so that the "responsibility for the decision in determining whether the fiduciary duty has been breached rests with the court." [9]

Moreover, the divided decision of the Third Circuit in *Weiss* conflicts with its decision in *Lewis* v. *Curtis*, 671 F.2d 779, 785-86 (3d Cir. 1982). There, the court stated that the same standards which govern the permissibility of directorial termination also dictate the requirement, or lack thereof, of shareholder demand:

> "There is no reason why a court, in deciding whether a board is sufficiently interested to excuse demand, should not be informed by the same factors used to determine whether a court should defer to the board's decision not to pursue the action."
>
> ". . . [W]e do not think that we would apply different standards of 'interestedness' to cases in which plaintiff has made no demand and to those in which the demand has been made and rejected."

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[8] H. Rep. No. 2337, 89th Cong.2d Sess., p. 131 (1966).

[9] S.Rep. No. 91-184, 91st Cong.1st Sess., p. 6 (1969).

To the extent that demand and termination may be treated differently, it would appear that principles of state corporate law generally require the plaintiff to make a stronger showing in order to survive a termination motion than to justify the absence of demand. Courts unwilling to dismiss for demand may nevertheless grant termination motions.[10] The corollary suggests that the present posture of the respondent is even stronger than that of the hypothesized terminated plaintiff. Section 36(b) provides shareholder access to the courts, and this Court has held that no board of directors or committee thereof, no matter how pure, may cut off that litigation, unless it be frivolous. The present suit is not frivolous. To extinguish it by the imposition of a procedure not intended by Congress would frustrate the legislative will and the right of investment company shareholders.

[10] Compare *Auerbach* v. *Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994 (1979) with *Barr* v. *Wackman*, 36 N.Y.2d 371, 329 N.E.2d 180 (1975). Virtually all of the cases dealing with dismissals by special litigation committees have arisen in so-called "demand excused" siutations. See, *e.g.*, *Zapata Corp.* v. *Maldonado*, 430 A.2d 779 (Del. 1981); *Lewis* v. *Anderson*, 615 F.2d 778, 780 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980).

CONCLUSION

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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No. 82-1200

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

DAILY INCOME FUND, INC. and REICH & TANG, INC.,
Petitioners,

—v.—

MARTIN FOX,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' REPLY BRIEF

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October 21, 1983

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Overview

Respondent concedes, at least implicitly, that Rule 23.1 requires a demand by a shareholder on the directors in a derivative action. Respondent argues, however, that a shareholder's action under § 36(b) is not a derivative action. The underpinning of Respondent's argument is that an investment company itself allegedly has no implied right of action to recover excessive advisory fees from its investment adviser.

Respondent's argument is without merit and, if adopted, would work an utterly incongruous result. Consider the following: if a new slate of directors of an investment company, upon reviewing the work of their predecessors, concluded that the investment company had been charged excessive advisory fees, could Congress possibly have intended to prevent the new slate of directors from instituting an action to recover excessive advisory fees? Even if no shareholder raised the matter? Obviously not. It makes no sense whatever to suggest that Congress intended to leave an investment company powerless to recover excessive advisory fees because a *shareholder* does not happen to raise the matter.

In short, under Respondent's interpretation of § 36(b), the independent directors would have less power than a single shareholder to recover excessive advisory fees, despite the independent directors' undeniable legal responsibility for the management of the investment company. This result would clearly conflict with the purpose of § 36(b), which was "designed to strengthen the ability of the unaffiliated directors to deal with these matters." S. Rep. No. 184, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. & Admin. News 4897, 4903.

Reply to Point I—

A shareholder's action under § 36(b) is derivative and, accordingly, Rule 23.1 is applicable.

The language and the legislative history of § 36(b) demonstrate that Congress considered a shareholder's action under § 36(b) to be derivative.

First, as argued in our main brief, the language of § 36(b) itself (". . . on behalf of such company . . .") indicates that a shareholder's action is derivative (Petitioners' Brief, p.5). See *Burks* v. *Lasker*, 441 U.S. 471, 477 (1979).

Second, as also argued in our main brief, the legislative history of § 36(b) evidences the fact that Congress considered a shareholder's action under § 36(b) to be derivative (Petitioners' Brief, pp. 6-8; see also ICI Brief, pp. 19-24).

At the heart of Respondent's contention that a shareholder's action under § 36(b) is not derivative and that Rule 23.1 therefore does not apply,[1] is the argument that an investment company itself allegedly has no implied right of action under § 36(b) to recover excessive advisory fees. That argument is based on an erroneous view of the legislative history of § 36(b).

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1 The SEC, which has filed an amicus curiae brief in this case despite its lack of any special expertise on the Federal Rules of Civil Procedure, takes the position that Rule 23.1 does not itself require that demand be made but only that the fact of such demand or the excuse for lack of demand be pleaded (SEC Brief, pp. 7-8). Although Rule 23.1 is worded as a pleading requirement, its history clearly establishes that it is intended to require director demand, and the courts have uniformly interpreted it this way. See 3B Moore's Federal Practice ¶¶ 23.1.15[4] and 23.1.19 (2d ed. 1980).

Respondent first argues that a right of action should not be implied since Congress has provided an express remedy to a shareholder and the SEC, as part of "a comprehensive legislative scheme" (Respondent's Brief, p. 6). The flaw in this argument is that the ICA is not, as Respondent claims, "a comprehensive legislative scheme." Rather, as this Court held in *Burks* v. *Lasker, supra*, 441 U.S. at 478, it is state corporation law, not the ICA, which is the source of authority for the managerial powers of investment company directors. Accordingly, the absence of any express authorization in § 36(b) for an action by an investment company should not be interpreted to restrict the company's right to sue. *Weiss* v. *Temporary Investment Fund, Inc.*, 692 F.2d 928, 935 (3d Cir. 1982).

In addition, as this Court reiterated in *Herman & MacLean* v. *Huddleston*, ____ U.S. ____, 103 S.Ct. 683, 690 n.23 (1983), the canon of statutory construction which opposes the implication of a remedy because another remedy has been expressly provided should be " 'subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose.' " As this Court held in *Burks* v. *Lasker, supra,* 441 U.S. at 484-85, the dominating general purpose of the 1970 amendments to the ICA, which included § 36(b), was to strengthen the role of the independent directors. To deny an investment company a right of action under § 36(b), and thereby to permit a shareholder to bypass the independent directors by bringing a § 36(b) action without making a director demand, is inconsistent with that purpose and this Court's holding in *Burks*.

Respondent next argues that the rejection by Congress of a bill proposed by the Investment Company Institute ("ICI"), which specifically authorized an investment com-

pany to sue to recover excessive advisory fees but denied such right of action to the SEC, demonstrates that Congress did not intend to permit an investment company to bring a § 36(b) action (Respondent's Brief, pp. 8-10). However, there is no evidence in the legislative history that Congress considered and expressly rejected the idea of authorizing an investment company to sue for recovery of excessive advisory fees. Rather, the issue which was debated was whether the *SEC* should be authorized to sue for the recovery of excessive advisory fees. As the SEC admits (SEC Brief, p. 18), the ICI's proposed bill was rejected because of its negation of SEC suits, not because of its express recognition of investment company suits.[2]

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2 The SEC points out that other proposed bills authorized the SEC to intervene in suits to enforce the fiduciary duty of advisers brought "by or on behalf of a registered investment company", whereas § 44, as passed, permits SEC intervention in any § 36(b) action, and § 36(b) refers specifically only to suits by shareholders on behalf of the investment company (SEC Brief, pp. 17-19). From this subtle change in a provision that did not even deal with private rights of action, the SEC contends that Congress manifested its intent to deny to investment companies the authority to assert on their own behalf the right to recover excessive advisory fees. However, there is not a single word in the legislative history indicating that this was the reason for the change. "[S]tatutory interpretation cannot rest on unexplained actions of a Congressional committee." *United States* v. *Imperial Irrigation District*, 559 F.2d 509, 535 (9th Cir. 1977). The change in the language of the provision dealing with SEC intervention might just as reasonably have reflected Congress' awareness that a shareholder's action was derivative and that it was therefore unnecessary to specify that a suit to recover excessive advisory fees could also be brought by an investment company. See *United States* v. *Wise*, 370 U.S. 405, 411 (1962). In view of the whole thrust of § 36(b) to strengthen the role of the independent directors, it is highly unlikely that Congress would have deprived them of this remedy without a word of comment. See *Watt* v. *Alaska*, 451 U.S. 259, 271 n.13 (1981).

Respondent then argues against an investment company's right of action under § 36(b) by pointing to the evidence of Congressional intent to provide shareholders with an effective remedy for excessive advisory fees (Respondent's Brief, pp. 10-13). This argument proves nothing. The implication of a right of action by an investment company would not in any way diminish the effectiveness of the shareholders' remedy—it would merely add another remedy. As this Court recognized in *Herman & MacLean* v. *Huddleston*, *supra*, 103 S.Ct. at 689, such a "cumulative construction" of a statute to provide additional remedies is to be favored where, as here, it furthers the "broad remedial purposes" of the statute.

Nor is an investment company's right of action under § 36(b) inconsistent with the purpose of § 36(b). As Respondent concedes, § 36(b) was intended "to strengthen the role of disinterested directors" with respect to advisory fees (Respondent's Brief, p. 13). This Court "cannot interpret federal statutes to negate their own stated purposes." *New York State Department of Social Services* v. *Dublino*, 413 U.S. 405, 419-20 (1973). Contrary to Respondent's bare assertion (Respondent's Brief, p. 13), there is no evidence that Congress "mandated" a conflict between the goals of strengthening the role of the independent directors and providing an effective judicial remedy. Accordingly, § 36(b) should be interpreted to further its overall purpose of preventing excessive advisory fees. See *FTC* v. *Meyer*, 390 U.S. 341, 349 (1968). The implication of a right of action under § 36(b) by an investment company is clearly consistent with that purpose.[3]

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3 In a similar vein, the SEC argues that the legislative history of § 36(b) reflects "a congressional determination that, due to

Respondent also challenges our reliance on the testimony of Chairman Budge of the SEC, claiming that he intended to refer to Rule 23, not Rule 23.1 (Respondent's Brief, pp. 14-16).[4] However, Chairman Budge's testimony dealt with the subject of safeguards against frivolous or harassing "shareholder actions." Hearings on H.R. 11995, S.2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. at 201 (1969). Rule 23.1 sets forth the requirements applicable to a shareholder's action, whereas Rule 23, by contrast, is concerned with class actions. A shareholder's action to recover excessive advisory fees (both before and after the 1970 amendments to the ICA) is brought on behalf of the investment company to enforce secondary, not primary, rights of the shareholder. Thus, Rule 23.1, not Rule 23, is applicable to such an action.

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conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors" and that this determination "is fundamentally inconsistent with the underlying rationale of the traditional demand requirement." (SEC Brief, p. 9). This argument misconstrues Congress' decision to provide judicial review of advisory fee contracts as demonstrating a complete and utter distrust of any involvement by the directors in the process of assessing the fairness of those fees. Such a conclusion conflicts with the purpose of the ICA to make the independent directors the "watchdogs" of the investment company's affairs. The director demand requirement, by giving the independent directors an opportunity to resolve a fee dispute short of litigation is consistent *both* with the purpose of strengthening the role of the independent directors *and* with that of providing an effective judicial remedy if litigation should ensue.

4 The requirements for derivative actions were previously contained in Rule 23(b) and were moved to Rule 23.1 by the 1967 amendments to the Federal Rules of Civil Procedure.

See 3B Moore's Federal Practice, *supra*, ¶ 23.1.16[1] at 23.1-42. Indeed, Respondent has failed to cite a single case which has treated a § 36(b) action, or its common law or statutory predecessor, as a class action or has applied Rule 23. It is therefore apparent that Chairman Budge meant to refer to Rule 23.1, not Rule 23, in speaking of the existing safeguards against frivolous shareholder actions, as the Courts of Appeals for both the First and Third Circuits concluded. *Grossman* v. *Johnson*, *supra*, 674 F.2d at 122; *Weiss* v. *Temporary Fund, Inc.*, *supra*, 692 F.2d at 938.[5]

In arguing that a shareholder's action is not "strictly speaking" a derivative action, Respondent compares § 36(b) to § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (Respondent's Brief, pp. 15-16, n.6). That analogy has been rejected as specious by every court that has considered it because § 16(b) contains its own express director demand language. *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 938-39; *Grossman* v. *Johnson*, *supra*, 674 F.2d at 120.[6]

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5 The SEC claims that even if Chairman Budge meant to refer to Rule 23.1, he was not referring to the director demand requirement but only to the requirement of court approval of settlements (SEC Brief, p. 21 n. 11). There is no basis for that distinction: if § 36(b) actions are indeed derivative, all of Rule 23.1 applies. Moreover, it is not true, as the SEC argues, that the director demand requirement does not serve to deter strike suits. In responding to a demand in connection with a frivolous claim, the directors might succeed in convincing the shareholder that his claim is without merit and/or that suit is not in the best interests of the investment company.

6 The Court of Appeals, while adopting Respondent's other arguments, did not pass on the § 16(b) analogy.

Respondent also relies on the fact that although other procedural requirements are mentioned, there appears to be no specific reference in the legislative history of the 1970 amendments to the director demand requirement (Respondent's Brief, pp. 16-19).[7] However, it is not surprising that the director demand requirement was not singled out for discussion. In light of the fact that the predecessor actions were derivative and the fact that Congress evidenced its understanding that a shareholder's action under § 36(b) would be derivative (see Petitioners' Brief, pp. 7-9 and ICI Brief, pp. 19-20 and nn.43 and 44), Congress reasonably assumed that all of the traditional rules pertaining to derivative actions would apply. This understanding is evident from the House bill cited by Respondent (Respondent's Brief, p. 18) which, unlike § 36(b) as passed, required that a plaintiff challenging advisory fees be a "bona fide shareholder." H. 17333, 91st Cong., 2d Sess. (1970). The report accompanying that bill stated that this requirement was not intended as a substantive change. H.Rep.No. 1382, 91st Cong., 2d Sess. at 7 (1970). The reason that no substantive change was intended, and the provision was therefore superfluous, is that the requirement that plaintiff be a bona fide shareholder already applied to all derivative actions. See

7 Although there appears to be no specific mention of the director demand requirement, reference was made to the shareholder demand requirement in the course of testimony on the issue of whether, in addition to shareholders, the SEC should be authorized to sue to recover excessive advisory fees. One of the reasons advanced for allowing such SEC actions was that shareholder suits would be subject to the usual prerequisites applicable to all derivative actions—including the shareholder demand requirement. Hearings on S.34 and S.296 Before the Comm. on Banking and Currency, 91st Cong., 1st Sess. (1969) at 163 (Statement of Ernest L. Folk, III, Professor of Law, University of Virginia).

13 W. Fletcher, Cyclopedia of the Law of Private Corporations § 5972 (rev. perm. ed. 1980).[8]

Finally, Respondent argues that a right of action by an investment company under § 36(b) should not be implied (despite the undisputed evidence of Congress' awareness that derivative actions to recover excessive advisory fees existed at common law and were implied under former § 36 of the ICA, because § 36(b) allegedly created "a totally new cause of action" (Respondent's Brief, p. 20). The error in this argument is that § 36(b) did not create "a totally new cause of action." Rather, § 36(b) represented an effort to cure certain perceived weaknesses in the legal standard ("corporate waste") applicable to common law derivative actions to recover excessive advisory fees. See S.Rep.No. 184, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. and Admn. News 4897, 4901, 4910. Furthermore, Congress was clearly aware that the courts had generally implied a derivative right of action to recover excessive advisory fees under former § 36 of the ICA. See Hearings on S.34 and S.296 Before the Senate Comm. on Banking and Currency, 91st Cong., 1st Sess. at 30 (letter from SEC Commissioner Owens to Senator Sparkman and cases cited in Petitioners' Brief, p. 10). Accordingly, in the absence of any evidence that Congress intended to abolish the pre-existing derivative action (and

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8 Indeed, if, as Respondent argues, a shareholder's action under § 36(b) were not derivative, then it would logically follow that *no* part of Rule 23.1 applies to such an action, including the contemporaneous ownership requirement. Such a result would give license to "strike suits" by permitting persons to purchase shares for the sole purpose of initiating litigation. The two requirements—director demand and contemporaneous ownership—are integral parts of a whole and, therefore, both or neither are applicable.

hence, the right of an investment company to sue its advisor to recover excessive fees), this Court should hold that Congress intended to preserve that remedy as part of § 36(b). *Merill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353 (1982).

Reply to Point II—

The director demand requirement of Rule 23.1 is compatible with § 36(b).

Respondent also argues that the director demand requirement is inconsistent with the operation of § 36(b) and serves no useful purpose. This argument is contrary to the goal of the 1970 amendments to the ICA to strengthen the role of the independent directors and is devoid of merit.

Respondent first claims that § 36(b) preempts all state law remedies for excessive advisory fees (Respondent's Brief, p. 22). Although Respondent purports to rely on *Burks* v. *Lasker*, 441 U.S. 471, 479 n.6 (1979) for this sweeping and novel claim, *Burks* is to the contrary. The existence of additional state law remedies is in no way "inconsistent" with § 36(b), and there is no need for uniformity "as long as private causes of action are available in federal courts for violation of the federal statutes . . . ." *Burks* v. *Lasker*, *supra*, 441 U.S. at 413 and n.6. Respondent fails to cite a single case which holds that § 36(b) has preempted state law remedies. Indeed, even courts which have held that § 36(b) provides the exclusive federal remedy for excessive advisory fees have recognized that state causes of action for breach of fiduciary duty remain as additional remedies. E.g. *Tarlov* v. *Paine*

Webber Cashfund, Inc., 559 F.Supp. 429 (D.Conn. 1983).[9]

Respondent also argues that even if an investment company has a state law remedy for excessive advisory fees, that would not justify a director demand requirement because the legal standard applicable to a common law action for corporate waste is different from that applicable to a § 36(b) action (Respondent's Brief, p. 23). However, even if that were true, the fact remains that the right to recover excessive advisory fees is "a right which may properly be asserted by" an investment company. See Rule 23.1. A shareholder's action to assert that right on behalf of an investment company is therefore derivative and a director demand is required.

Respondent goes on to argue that director demand is useless because the close relationship between the directors of the investment company and the adviser make it unlikely that informal means of redressing excessive fees will be successful (Respondent's Brief, pp. 23-24). This is a cynical view and is inconsistent with the legislative history of § 36(b). If Congress did not feel that the directors were capable of acting with independence, it would not have assigned them the critical role of reviewing advisory fees. See *Burks* v. *Lasker, supra,* 441 U.S. at 485 n.15.[10]

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9 If, as Respondent contends, § 36(b) preempts state law remedies and provides no right of action by an investment company, then the investment company would have *no* judicial remedy to recover excessive advisory fees. That result is hardly consistent with the goal of strengthening the authority of the independent directors.

10 In a slightly different version of the same argument, the SEC contends that director demand would be useless because (1) the independent directors, having already approved the advisory fee

Respondent also contends that the director demand requirement of Rule 23.1 cannot be imposed without converting a procedural rule into a substantive requirement, thereby violating the Enabling Act, 28 U.S.C. § 2972 (Respondent's Brief, p. 25). No cases are cited by Respondent to support this proposition, and *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541, 556 (1949), which the SEC relies on (SEC Brief, p. 8), is inapposite because *Cohen* did not involve the director demand requirement. Moreover, the question as to whether Rule 23(b) had to be amended in light of the *Erie* doctrine was specifically presented to this Court in the Advisory Committee Note of 1946, but this Court did not then amend the Rule and has not done so since because of this consideration. 3B Moore's Federal Practice, *supra*, ¶ 23.1.01. In any event, this issue need not be decided, since this is not a diversity action but rather a suit arising under a federal statute. Accordingly, director demand is properly required by Rule 23.1. See *Levitt* v. *Johnson*, 334 F.2d 815, 819 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965).

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agreement, would not be learning of any new claim; and (2) the bargaining power or the investment company is reduced because it cannot bring a § 36(b) action (SEC Brief, pp. 24-25). These arguments find no support in the legislative history and are also erroneous. Approval of a transaction by the directors does not, by itself, excuse demand before the commencement of a shareholder suit challenging that transaction. See cases cited in Petitioner's Brief, p. 10. Furthermore, although the independent directors are necessarily aware of the fee issue, a demand can serve to focus their attention on some particular question or evidence which was overlooked during their annual review of the advisory contract. And whether or not an investment company can bring a § 36(b) action, it clearly has greater bargaining leverage than an individual shareholder, since it has the power to terminate the contract.

Respondent also claims that director demand serves no purpose because § 36(b)(2) prevents an investment company from terminating a suit (Respondent's Brief, pp. 25-28). That argument is founded on an overly narrow view of the purposes of the director demand requirement and has already been answered (see Petitioners' Brief, pp. 21-24). The only new point raised by Respondent is that in *Lewis* v. *Curtis*, 671 F.2d at 779, 785-86 (3d Cir.), cert. denied, ____ U.S. ____, 103 S.Ct. 176 (1982), the Third Circuit stated "that the same standards which govern the permissibility of directorial termination also dictate the requirement, or lack thereof, of shareholder demand" (Respondent's Brief, p. 27). However, in *Weiss* v. *Temporary Investment Fund, Inc., supra*, 692 F.2d at 942, the Third Circuit considered this argument at length and rejected it, holding that:

> ". . . the different purposes served by the business judgment rule and the demand requirement show that the wooden transposition of *Lewis* to this statutory context is inappropriate. *Lewis* was concerned with the futility of demand. It involved an inquiry which is 'intensely factual' and requires particularized pleading by the plaintiff. See *Vernars* v. *Young*, 539 F.2d 966, 968 (3d Cir. 1976). In a conventional shareholder suit, the evaluation of the directors' decision to refuse demand or terminate suit is equally factual, and it makes sense, as we stated in *Lewis*, to employ the same standard of interestedness. However, a statutory presumption of interestedness cannot substitute for the factual inquiry needed to determine whether a demand on directors 'would be likely to prod them to correct a wrong.' *Lewis, supra*, 671 F.2d at 785."

We have already dealt with the argument that the director demand requirement is inconsistent with § 36(b)(3), which limits recovery to damages beginning one year before commencement of the action (see Petitioners' Brief, pp. 24-26). Conceding that satisfaction of the director demand requirement will not necessarily reduce the amount of plaintiff's recovery, the SEC objects that the delay caused by the director demand requirement would cause an additional portion of the allegedly excessive fees to pass beyond the reach of the Court (SEC Brief, pp. 25-26). However, the purpose of § 36(b) was not to provide for the recovery of every dollar of excessive advisory fees received by an adviser; the one-year limitation period itself prevents this. Rather, § 36(b) serves to provide an effective equitable remedy against excessive advisory fees which include a monetary award covering the year prior to suit to serve as an incentive. The effectiveness of this remedy is not diminished by requiring director demand which, as the Third Circuit noted, can be "promptly made and expeditiously considered." *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 938.

Conclusion

The judgment of the Court of Appeals should be reversed, and the Complaint should be dismissed.

Respectfully submitted,

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October 21, 1983

No. 82-1200

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

DAILY INCOME FUND, INC. and REICH & TANG, INC.,
Petitioners,

v.

MARTIN FOX

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF, *AMICUS CURIAE,*

and

BRIEF, *AMICUS CURIAE*, OF THE INVESTMENT COMPANY INSTITUTE

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MOTION FOR LEAVE TO FILE BRIEF, *AMICUS CURIAE*

Pursuant to Rules 36.3 and 42 of this Court's Rules, the Investment Company Institute (the "Institute") hereby respectfully moves for leave to file the attached brief, *amicus curiae*, in the above-captioned case. The petitioners have consented to the filing of such a brief; the respondent has declined to consent to the filing of this brief.

The Institute is the national association of open-end investment companies (otherwise known as mutual funds), their investment advisers and their principal underwriters. The Institute has 884 investment company members with approximately 16 million shareholders, and assets of approximately $264.5 billion. The Institute is generally recognized as the primary spokesman for the mutual fund industry and, as such, was intimately involved in the 1970 legislative enactment of Section 36(b) of the Investment Company Act of 1940, the statute principally involved in this action.

The decision below articulates an unprecedented and damaging theory of the role independent mutual fund directors were intended to perform. If left unchanged, that decision will permit needless, costly, ill-founded and potentially abusive litigation against the members of the Institute. Leave of this

Court is sought to offer the Institute's unique perspective on the proper resolution of the important issues raised by the parties, so that the decision in this case can most effectively be reconciled with the structure and purposes of the Investment Company Act and Rule 23.1 of the Federal Rules of Civil Procedure.

For the foregoing reasons, the Institute should be permitted to file the attached brief, *amicus curiae*.

Respectfully submitted,

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April 21, 1983

QUESTION PRESENTED

The Institute adopts, by reference, the question presented by the petitioners:

> Is a shareholder's derivative action under Section 36(b) of the Investment Company Act of 1940 exempt from the director demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure?

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute (the "Institute") files this brief, *amicus curiae,* in support of the petitioners' prayer that the judgment of the United States Court of Appeals for the Second Circuit, entered on October 26, 1982, be reversed.

INTEREST OF THE INVESTMENT COMPANY INSTITUTE

The Institute is the national association of open-end investment companies (otherwise known as mutual funds), their investment advisers and their principal underwriters. The Institute has 884 investment company members, with approximately 16 million shareholders and assets of approximately $264.5 billion. The assets of the Institute's members account for over 92 percent of the total assets of the mutual fund industry. The Institute's mutual fund members are registered with the United States Securities and Exchange Commission (the "SEC") under the Investment Company Act of 1940, as amended, 15 U.S.C. §§80a-1, *et seq.,* and are subject to detailed statutory prescriptions regarding their structure, operations and governance.[1]

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[1] *See, e.g., Burks* v. *Lasker,* 441 U.S. 471, 478 (1979); *United States* v. *National Association of Securities Dealers, Inc.,* 422 U.S. 694, 705 n. 13 (1975).

The Institute is concerned that the decision below will undermine the statutory role of independent mutual fund directors, and will permit needless, costly, ill-founded and potentially abusive litigation against mutual funds and their investment advisers.

For the reasons set forth below, the Institute respectfully submits that the decision of the Court of Appeals is incorrect as a matter of law, because it contravenes the express language employed by Congress regarding mutual fund shareholder litigation of the type involved here, and because it is inconsistent with the provisions and policies of *both* the Investment Company Act and the Federal Rules of Civil Procedure.

OPINIONS BELOW

The opinion of the Court of Appeals (per Kaufman, J.) (A. 23a)[2] is reported as 692 F.2d 250 (C.A. 2, 1982). The opinion of the District Court (per Duffy, J.) (A. 11a) is reported at 94 F.R.D. 94 (S.D. N.Y., 1982).

JURISDICTION

The judgment of the Court of Appeals was entered on October 26, 1982. A timely petition for a writ of certiorari was filed on January 17, 1983, and was granted on March 7, 1983. The Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTES AND RULES INVOLVED

Sections 15 and 36(b) of the Investment Company Act of 1940, as amended (the "ICA" or the "Act"), 15 U.S.C. §§ 80a-15 and -35(b), and Rule 23.1 of the Federal Rules of Civil Procedure ("Rule 23.1"), are relevant to the disposition of this action.

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[2] References to the Joint Appendix filed in this Court are cited as "A. ."

STATEMENT OF THE CASE

This suit was commenced on April 30, 1981, by Martin Fox, a shareholder of petitioner Daily Income Fund, Inc. (the "Fund")—a Maryland corporation which is an open-end investment company (or mutual fund) registered with the SEC (A. 5a-6a). Characterizing his suit as a "*derivative* action brought under § 36(b) [of the ICA]," [3] the plaintiff's complaint (A. 5a) stated, as expressly required by ICA Section 36(b), that the action was brought *solely* "on behalf of the Fund," and challenged the level of advisory fees paid by the Fund to its investment adviser, petitioner Reich & Tang, Inc.[4] Consistent with the "derivative" nature of his lawsuit, the plaintiff sought relief *exclusively for the Fund,* and not on his own behalf, save for his request for costs and attorney's fees (A. 8a).

As required by the ICA, the Fund's payment of advisory fees to Reich & Tang was governed by an explicit advisory contract, which specified the services Reich & Tang was to perform, and the level of fees Reich & Tang was entitled to receive.[5] The contract was approved by a vote of a majority of the Fund's outstanding shares [6] and, as also required by statute, has thereafter been subjected to annual review, evaluation and approval by the Fund's five directors, three of whom are independent, or disinterested, directors within the meaning of

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[3] *See* Plaintiff's Memorandum in Opposition to Motion to Dismiss, at 3 (emphasis supplied).

[4] The complaint does not specify which fees are challenged, or in what amount. By statute, however, the plaintiff's claims must be limited to some portion of the advisory fees paid from May 1, 1980, to April 30, 1981. *See* ICA Section 36(b)(3), 15 U.S.C. § 80a-35(b)(3).

[5] *See* ICA Section 15(a), 15 U.S.C. § 80a-15(a); Proxy Statement of Daily Income Fund, Inc., filed with the SEC on September 21, 1981, at 11, Exhibit A (hereinafter "1981 Proxy Statement").

[6] *See* Proxy Statement of Daily Income Fund, Inc., filed with the SEC on September 12, 1980, at 6 (hereinafter "1980 Proxy Statement").

the Act.[7] The Fund's advisory contract with Reich & Tang also provides, as required by law, that the Fund may terminate the agreement at any time, for any reason, without any penalty, upon sixty days' written notice.[8]

The plaintiff's complaint does not dispute that Reich & Tang has performed the services it contracted to perform, nor does the complaint dispute that the independent directors have annually reviewed, evaluated and approved the Fund's advisory contract with Reich & Tang. Instead, the complaint challenges only the wisdom of the judgment, approved by the Fund's other shareholders, and thereafter annually reconfirmed by the Fund's directors, that the advisory contract was and is fair to the Fund and in its best interests.[9]

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[7] *See* ICA Sections 15(a)(2) and 15(c), 15 U.S.C. §§ 80a-15(a)(2) and -15(c). A director is deemed to be disinterested, within the meaning of the Act, if, *inter alia*, he does not own or control, directly or indirectly, five percent or more of the outstanding shares of the fund, has no affiliation with the investment adviser, and has no prior business or professional relationship with the fund. *See* ICA Sections 2(a)(3) and 2(a)(19), 15 U.S.C. §§ 80a-2(a)(3) and -2(a)(19).

The three disinterested directors of the Fund are W. Giles Mellon, Professor of Business Administration in the Graduate School of Business Administration, Rutgers University; Alan J. Patricof, head of a private investment corporation; and Dr. Yung Wong, managing director of a venture capital firm. *See* Defendant's Affidavit in Support of Motion to Dismiss, at 2.

[8] *See* 1980 Proxy Statement, at 7; 1981 Proxy Statement, at 13. *Compare* ICA Section 15(a)(3), 15 U.S.C. § 80a-15(a)(3).

[9] Under the ICA, a majority of a mutual fund's shareholders must initially approve an advisory contract; for subsequent annual approvals of the contract, the statute requires a vote of a majority of *either* a fund's shareholders *or* a fund's board of directors, *and* approval by a majority of a fund's *independent* directors. *See* ICA Sections 15(a)(2) and 15(c), 15 U.S.C. §§ 80a-15(a)(2) and -15(c).

In this case, after receiving initial approval from its shareholders for the Fund's advisory contract with Reich & Tang, the Fund has disclosed each year to its shareholders the terms of the agreement and the fees paid to Reich & Tang under it. *See* Proxy Statements of Daily Income Fund filed with the SEC on October 17, 1975, at 5-7; August 30, 1976, at 3-5; August 29, 1977, at 3-4; September 1, 1978, at 6-8; August 31, 1979, at 5-6; September 12, 1980, at 6-7.

Despite the fact that his suit was filed "on behalf of the Fund" (A. 5a), and despite the fact that the majority of the Fund's directors are disinterested, the plaintiff eschewed the longstanding equitable mandate now embodied in Rule 23.1 that intracorporate remedies be exhausted prior to the commencement of a suit brought to vindicate corporate, as opposed to individual, rights. The plaintiff purported to justify his failure to comply with Rule 23.1 by asserting, first, that demand was excused, *as a matter of law*, in *any* action under ICA Section 36(b), and by asserting, alternatively, but without explanatory detail, that in this case "all of the directors are beholden to [Reich & Tang] for their positions and have participated in the wrongs complained of in this action" (A. 8a).[10] Deprived of any opportunity to evaluate and determine how best to resolve the plaintiff's charges, the Fund moved to dismiss the complaint for failure to comply with the prescriptions of Rule 23.1 (A. 1a).

Based on its examination of the Act and its legislative history, the District Court concluded that, absent exceptional circumstances not alleged here, demand is a prerequisite to a shareholder's derivative action under Section 36(b) (A. 15a). 94 F.R.D. at 96. Noting that Congress had intended that "the board of directors is to be the first line of defense" for charges of self-dealing by a mutual fund's investment adviser, Judge Duffy held it was "not unreasonable" to require a shareholder "first [to] bring a problem to the board of an investment company . . .," since "[t]he unaffiliated directors can easily solve the problem (if it be real) without the need for litigation . . . " (A. 15a). *Id.*

On appeal, the Second Circuit reversed. It held that a mutual fund shareholder need ***never*** "afford the fund an opportunity to vindicate its [that is, the fund's] rights because," the court assumed, "such a [demand] requirement would [likely] be an empty, unfruitful and dilatory exercise" (A. 49a). 692 F.2d at 262.

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[10] As noted by this Court in *Burks* v. *Lasker, supra*, 441 U.S. at 485 n. 15, this allegation is inconsistent with the express provisions of Section 2(a)(19) of the ICA, 15 U.S.C. § 80a-2(a)(19).

Despite both the plaintiff's and the appellate court's recognition that the rights created under ICA Section 36(b) belong solely to the Fund, and despite the appellate court's recognition that a panoply of "informal methods of attempting to recoup excessive adviser fees . . ." may be available to the Fund and its independent directors, the court below held that, in order for the demand requirement to apply, a mutual fund must be able "to 'assert,' in a court, the same action under the same rule of law on which the shareholder plaintiff relies" (A. 29a & n. 7). 692 F.2d at 254 & n. 7. In the belief that the Fund could not have commenced its own suit, *pursuant to ICA Section 36(b)*—a belief contradicted by the other appellate courts to consider the same issue[11]—the court below held that the salutary "policy behind requiring demand" had been rendered "superfluous" (A. 46a). 692 F.2d at 261.

SUMMARY OF ARGUMENT

The demand requirement of Rule 23.1, a *sine qua non* to shareholder litigation, is premised upon the fundamental principle that the board of directors is responsible for overseeing the management of corporate affairs and, therefore, should be given the first opportunity to vindicate corporate rights. A corporation itself is in the best position to seek redress of a shareholder's grievance, perhaps without resort to litigation, and the demand requirement serves to protect a company from vexatious "strike" suits brought solely for their nuisance value. Given these salutary purposes of the demand requirement, a strong presumption exists that Rule 23.1 applies to *all* derivative actions.

The plaintiff has failed to demonstrate that Congress intended to deny the applicability of these principles to actions under ICA Section 36(b); in fact, the ICA's provisions and

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[11] *See Grossman* v. *Johnson*, 674 F.2d 115 (C.A. 1), *cert. denied sub nom., Grossman* v. *Fidelity Municipal Bond Fund, Inc.*, ____U.S.____ 103 S. Ct. 85 (1982), *reh'g denied*, ____ U.S. ____, 103 S. Ct. 774 (1983); *Weiss* v. *Temporary Investment Fund, Inc.*, 692 F.2d 928 (C.A. 3, 1982).

legislative history demonstrate that Congress intended no such result. The board of directors of a mutual fund is primarily responsible for safeguarding fund shareholder interests, and is in a unique position to undertake measures to recover excessive fees, provided early notice is given to the board. For example, ICA Section 15 requires annual review of all advisers' contracts and permits a board of directors to terminate such contracts at any time without the payment of any penalty. Thus, the board can utilize the leverage of future fees to exact a return of past fees which may reap greater benefits to the fund and its shareholders than permitted under Section 36(b).

The legislative history of the 1970 Amendments to the ICA not only fails to overcome the presumption of Rule 23.1's applicability but, in fact, supports application of the demand requirement to Section 36(b) actions. Congress expressly intended that an investment company's unaffiliated board members be accorded a primary role in the management fee area, and Section 36(b) was meant to strengthen, not to undercut, this role. Perhaps even more important, Congress expressly assumed (and was so advised) that it could rely upon the requirements of Rule 23.1 as a means of avoiding the specter of a plethora of shareholder strike suits under Section 36(b).

The Court of Appeals held that, as a matter of law, Rule 23.1 was inapplicable to *all* shareholder suits under Section 36(b) because, in its view, the shareholder's action was not truly derivative within the meaning of Rule 23.1. This conclusion flies in the face of logic, legal precedent and the legislative history of the Act. The basis of a derivative action is a wrong to the corporation—the precise basis for an action under Section 36(b). The statute clearly states that the only rights that may be vindicated under its terms are rights belonging to the mutual fund, not to the shareholder asserting those rights.

Moreover, Section 36(b) is founded on the common law action for waste, an action firmly established to be derivative in nature. Section 36(b) provides a mutual fund shareholder no personal recovery; any sums awarded under the Act are

returned to the mutual fund's treasury. As in other derivative actions, dismissal of the suit or settlement by the plaintiff in a Section 36(b) action must be approved by the court, and the judgment, or settlement, is *res judicata*. Finally, the legislative history of Section 36(b) is replete with references to the "derivative" nature of an action under Section 36(b).

Application of the demand requirement here fulfills the fundamental policies of both the ICA and the Federal Rules of Civil Procedure. As this Court noted in *Burks* v. *Lasker, supra,* 441 U.S. at 484, Congress established the independent directors of a mutual fund as the primary "watchdogs" to protect the interests of mutual fund shareholders. The decision below would impermissibly "muzzle" these "watchdogs," and prevent them from performing their statutory mandate. Moreover, the independent directors of a mutual fund are in the best position to assess the merits of a shareholder's allegations. Timely compliance with the demand requirement enhances the capacity of these directors to resolve legitimate concerns without the need to resort to costly litigation, or to persuade shareholders who proceed in good faith that some claims are either unworthy of assertion or are inimical to the best interests of the mutual fund on whose behalf they are proposed to be asserted.

In short, no justification exists in the Act, its legislative history, relevant case law or public policy to support the decision of the Court of Appeals.

ARGUMENT

A SHAREHOLDER SUIT UNDER SECTION 36(b) OF THE INVESTMENT COMPANY ACT, LIKE ALL OTHER SHAREHOLDER DERIVATIVE ACTIONS, IS SUBJECT TO THE DEMAND REQUIREMENT EMBODIED IN RULE 23.1 OF THE FEDERAL RULES OF CIVIL PROCEDURE.

A. Exhaustion of Intracorporate Remedies Is A Fundamental And Necessary Prerequisite To The Privilege Of Instituting A Shareholder's Derivative Action.

Contrary to the assertion of the court below, full consideration of the important policies underlying the demand requirement now embodied in Rule 23.1 is hardly "superfluous." Indeed, we respectfully submit that such consideration is essential to the proper disposition of this case.

The stockholder's derivative action was created by the early equity courts to permit shareholders of a corporation to enforce a *corporate* right, or to prevent or remedy a wrong *to the corporation*, in certain, limited, cases where the corporation failed *and* refused (usually because the actual wrongdoers controlled the corporation) to take appropriate action for the corporation's own protection.[12] By its very nature, shareholder derivative litigation is extraordinary; it is one of the relatively few instances in which shareholders may be able to displace corporate directors in the management of corporate affairs. In creating a right of limited access to the judiciary by persons who, by definition, do not seek to vindicate their *personal* rights, the avowed purpose of the equity courts was, and is, to prevent inequity and injustice.[13]

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[12] *See, e.g., Ross* v. *Bernhard*, 396 U.S. 531, 534 (1970); *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541, 548 (1949); *Koster* v. *(American) Lumbermens Mutual Casualty Co.*, 330 U.S. 518, 522 (1947); *Meyer* v. *Fleming*, 327 U.S. 161, 167 (1946); *Ashwander* v. *Tennessee Valley Authority*, 297 U.S. 288, 319, *reh'g denied*, 297 U.S. 728 (1936); *Hawes* v. *City of Oakland*, 104 U.S. 450, 460 (1882).

[13] *See, e.g., Hawes* v. *City of Oakland*, *supra*, 104 U.S. at 454, 460.

Of course, derivative litigation may itself engender inequity or injustice: among other things, it displaces and disrupts the normal management of corporate affairs,[14] casts aspersions on corporate directors,[15] enmeshes the corporation in potentially costly and protracted litigation,[16] and is capable of producing results that may be inimical to the best interests of the corporation taken as a whole.[17] As this Court noted in *Cohen* v. *Beneficial Industrial Loan Corp., supra,* 337 U.S. at 548, the evils and abuses that can be engendered by derivative actions are real and awesome:

> Unfortunately, [derivative actions] provid[e] opportunity for abuse which has not [been] neglected. Suits sometimes [are] brought not to redress real wrongs, but to realize upon their nuisance value. They [are] bought off by secret settlements in which any wrongs to the general body of share owners [are] compounded by the suing stockholder, who [is] mollified by payments from corporate assets. These litigations [are] aptly characterized in professional slang as "strike suits." And it [is] said that these suits [are] more commonly brought by small and irresponsible than by large stockholders, because the former put less to risk and a small interest [is] more often within the capacity and readiness of management to compromise than a large one.

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[14] *See, e.g., United Copper Securities Co.* v. *Amalgamated Copper Co.,* 244 U.S. 261, 264 (1917).

[15] *See generally,* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions,* 44 U. Chi. L. Rev. 168, 168-72 (1976) (hereinafter "*Demand and Standing*").

[16] The corporation is a necessary party in a shareholder's derivative suit. *See, e.g., Ross* v. *Bernhard, supra,* 396 U.S. at 538; *Meyer* v. *Fleming, supra,* 327 U.S. at 167; *Price* v. *Gurney,* 324 U.S. 100, 105 (1945); *City of Davenport* v. *Dows,* 85 U.S. (18 Wall.) 626, 627 (1874).

[17] *See, e.g., Surowitz* v. *Hilton Hotels Corp.,* 383 U.S. 363, 371, *reh'g denied,* 384 U.S. 915 (1966); *Galef* v. *Alexander,* 615 F.2d 51, 57 (C.A. 2, 1980); *Landy* v. *Federal Deposit Insurance Corp.,* 486 F.2d 139, 146 (C.A. 3, 1973), *cert. denied,* 416 U.S. 960 (1974); *see generally,* J. Coffee & D. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform,* 81 Colum. L. Rev. 261, 308-09 (1981); *Demand and Standing, supra,* 44 U. Chi. L. Rev. at 168-72, 192-93.

For those reasons, this Court held, more than one hundred years ago, that a would-be derivative plaintiff must exhaust available intracorporate remedies before seeking redress in court:

> [The shareholder] should show, to the satisfaction of the court, that he has *exhausted all the means within his reach to obtain within the corporation itself, the redress of his grievances, or action in conformity to his wishes.* He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be apparent to the court .... And he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it.

Hawes v. *City of Oakland, supra,* 104 U.S. at 460-61 (emphasis supplied).[18]

The importance of this so-called demand requirement is difficult to overstate. Properly pursued, it can obviate the need for litigation, since the directors may be able to achieve a resolution of the alleged wrongs by negotiation or arbitration, or the directors may be able to persuade a shareholder (assuming the shareholder is proceeding in good faith) either that there is no merit to the claim or that the assertion of the claim is apt to do more harm than good *to the corporation.*[19] Since the rights to be asserted in a derivative suit belong, in every respect, *only to the corporation,* it is both necessary and appropriate that the corporation be given an early opportunity to evaluate the nature of its rights, and the proper methodology by which such rights should be asserted.[20]

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[18] *Accord, e.g., Wathen* v. *Jackson Oil & Refining Co.,* 235 U.S. 635 (1915); *Lewis* v. *Graves,* [Current Decisions] Fed. Sec. L. Rep. (CCH) ¶99,106, at 95,281 (C.A. 2, 1983); *Galef* v. *Alexander, supra,* 615 F.2d at 59.

[19] *See generally,* Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit,* 73 Harv. L. Rev. 746, 748-49 (1960), *and cases cited therein* (hereinafter "*Demand on Directors*").

[20] *See, e.g., United Copper Securities Co.* v. *Amalgamated Copper Co., supra,* 244 U.S. at 263-64; *Clark* v. *Lomas & Nettleton Financial Corp.,* 625 F.2d 49, 52, *reh'g denied,* 632 F.2d 894 (C.A. 5, 1980), *cert. denied,* 450 U.S. 1029 (1981); *Landy* v. *Federal Deposit Insurance Corp., supra,* 486 F.2d at 146; *see generally, Demand and Standing, supra,* 44 U. Chi. L. Rev. at 171-72, *and cases cited therein; Demand on Directors, supra,* 73 Harv. L. Rev. at 746-50.

B. The Application Of The Demand Requirement To Derivative Suits Under Section 36(b) Is Mandated By The Plain Language Of The Statute And Rule 23.1.

The substantive prerequisites to the maintenance of a shareholder's derivative action, first articulated by this Court in *Hawes* v. *City of Oakland, supra,* 104 U.S. at 460-61, are now embodied in Rule 23.1. [21] That Rule provides, in essence, that demand (or *justifiable* excuse for the failure to make demand) is a necessary condition precedent to the maintenance of shareholder derivative actions, which are defined by the Rule to mean actions "brought to enforce a *right* of the corporation . . ." (emphasis supplied).

The Court of Appeals held that the cause of action expressed in Section 36(b) was not a derivative action within the meaning of Rule 23.1 (A. 33a, 46a). 692 F.2d at 255, 261. But, ICA Section 36(b) provides that the only shareholder action that may be maintained under that section must be one brought *solely* to enforce a right "on behalf of" the investment company—the precise definition of a derivative action used in Rule 23.1. Thus, unless Rule 23.1 has somehow been rendered inapplicable to actions under Section 36(b), the plain language of Rule 23.1 and Section 36(b) read together mandates a prospective plaintiff's compliance with the demand requirements of Rule 23.1. [22]

The Federal Rules of Civil Procedure were promulgated "to meet the needs of an increasingly complex social organization, for efficient and workable court machinery."[23] Toward

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[21] The prescriptions of Rule 23.1 originally were promulgated as Equity Rule 94, 104 U.S. ix (1882), which later became Equity Rule 27, 226 U.S. 656 (1912), and, prior to Rule 23.1, were embodied in former Rule 23(b) of the Federal Rules of Civil Procedure, 308 U.S. 690 (1938). *See, e.g., Ross* v. *Bernhard, supra,* 396 U.S. at 534 n. 4; *Koster* v. *(American) Lumbermens Mutual Casualty Co., supra,* 330 U.S. at 522.

[22] It is axiomatic that, in construing a statute, the starting point is "the language of the statute itself." *See, e.g., Steadman* v. *Securities and Exchange Commission,* 450 U.S. 91, 97, *reh'g denied,* 451 U.S. 933 (1981); *Rubin* v. *United States,* 449 U.S. 424, 429 (1981).

[23] C. Clark & J. Moore, *A New Federal Civil Procedure,* 44 Yale L.J. 387, 387 (1935).

that end, the first of the Federal Rules establishes that those rules shall "govern the procedure in the United States district courts in *all* suits of a civil nature ... [and they] shall be construed to secure the just, speedy, and inexpensive determination of each action." Fed. R. Civ. P. 1 (emphasis supplied).

In recognition of Rule 1's manifest direction, this Court has commanded that all of the Federal Rules are presumptively applicable "[i]n the absence of a *direct expression* by Congress of its intent to depart from the usual course of trying 'all suits of a civil nature' under the Rules established for that purpose ...." *Califano* v. *Yamasaki*, 442 U.S. 682, 700 (1979) (emphasis supplied). A party to a civil action who seeks to abrogate a Federal Rule's applicability, therefore, necessarily bears a heavy burden of proof that such a result was intended.[24] That burden has not been sustained here.

The Court of Appeals held that the prescriptions embodied in Rule 23.1 apply only if the corporation (here, the Fund) is able to assert, in a court, exactly the same cause of action, under exactly the same statute, as is proposed to be asserted by the derivative shareholder plaintiff (A. 29a). 692 F.2d at 254. *Rule 23.1, however, plainly does not set forth such a test.* What the Rule *does* state is that the corporation must have "failed to enforce *a* right which properly may be asserted by it..." (emphasis supplied). But, this language refers to the *gravamen* of the derivative plaintiff's cause of action—that is, the Rule requires that there must be some properly assertable *right* that

[24] Although Congress has the authority to enact legislation which supersedes conflicting provisions of the Federal Rules of Civil Procedure, a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible. *See, e.g., Califano* v. *Yamasaki, supra*, 442 U.S. at 700; *Weiss* v. *Temporary Investment Fund, Inc., supra*, 692 F.2d at 936; *Grossman* v. *Johnson, supra*, 674 F.2d at 122-23; *United States* v. *Gustin-Bacon Div., Certain-Teed Products Corp.*, 426 F.2d 539, 542 (C.A. 10), *cert. denied*, 400 U.S. 832 (1970); *Markowitz* v. *Brody*, 90 F.R.D. 542, 549 (S.D. N.Y., 1981); *Untermeyer* v. *Fidelity Daily Income Trust*, 79 F.R.D. 36, 45 (D. Mass.), *vacated on other grounds*, 580 F.2d 22 (C.A. 1, 1978); 7 J. Moore, *Moore's Federal Practice* ¶86.04[4] (2d ed. 1980); Fed. R. Civ. P. 1.

has been breached, the corporation must be able to "assert" such a right (presumably, but not necessarily, in a court of law [25]), and the corporation must have failed to take steps to enforce that right.

Nothing in the language of Rule 23.1 requires, as the court below believed, that the corporation's "right" must "be properly . . . asserted" in a lawsuit that is identical in all respects to the lawsuit the corporation's shareholder proposes to institute derivatively.[26] Under Maryland law, the Fund would have a cause of action, identical *in substance* to the cause of action set forth in ICA Section 36(b), against the Fund's adviser if the Fund believed that it had been charged excessive advisory fees under its contract,[27] and nothing in the ICA would

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[25] In point of fact, the language of Rule 23.1 does not even require that the corporation's rights must be assertable *in a lawsuit*. In a number of early decisions, however, this Court indicated that it would permit a shareholder to institute a derivative action only if the corporation (on whose behalf the derivative action is to be instituted) could have instituted some type of lawsuit to resolve the actions that prompted the commencement of the derivative suit. *See, e.g., Delaware & Hudson Co.* v. *Albany & Susquehanna R.R. Co.*, 213 U.S. 435, 447 (1909).

That requirement, as with other prerequisites to derivative actions, was imposed not to *benefit* a derivative shareholder plaintiff, but rather, to *preclude* abusive and frivolous lawsuits by such shareholders. *Cf. Surowitz* v. *Hilton Hotels Corp., supra*, 383 U.S. at 371; *Hawes* v. *City of Oakland, supra*, 104 U.S. at 452-53. Where, as here, Congress has specifically authorized a shareholder's derivative suit to redress the specific wrongs challenged, there are no equitable considerations that would require a court to inquire whether the corporation itself could have maintained its own lawsuit.

[26] This court has repeatedly recognized, for example, that there is no requirement inherent in Rule 23.1, or otherwise, of absolute symmetry between a shareholder's derivative action and any action the corporation itself might be able to pursue on its own behalf. *See, e.g., Ross* v. *Bernhard, supra*, 396 U.S. at 533-34 (corporate action may be legal although shareholder derivative action is equitable); *Smith* v. *Sperling*, 354 U.S. 91 (1957) (corporation may be party defendant rather than aligned with plaintiff shareholder); *Hawes* v. *City of Oakland, supra*, 104 U.S. at 452 (derivative plaintiff may be able to sue in federal court, but corporation may be limited to state court); *Dodge* v. *Woolsey*, 59 U.S. (18 How.) 331 (1856) (same).

[27] *See, e.g., Feinberg* v. *George Washington Cemetery, Inc.*, 226 Md. 393, 174 A.2d 72, 74 (1961); *Llewellyn* v. *Queen City Dairy, Inc.*, 187 Md. 49, 48 A.2d 322, 326 (1946); *cf. Parish* v. *Maryland & Virginia Milk Producers Ass'n, Inc.*, 250 Md. 24, 242 A.2d 512, 544-45 (1968).

preclude the Fund from asserting such a cause of action under state law.[28] The Court of Appeals' contrary conclusion regarding the standard set forth in Rule 23.1 is predicated not on a fair reading of the language of the Rule, but rather, is based solely upon a misreading of this Court's previous decisions.[29]

Moreover, even if it is assumed, *arguendo*, that an investment company must be able to "assert, in a court, the same action under the same rule of law," as erroneously held by the Court of Appeals, that test is, in any event, satisfied here, since a mutual fund has a cause of action under Section 36(b). For approximately a decade prior to the adoption of the 1970 Amendments to the ICA, the federal courts consistently and repeatedly had recognized the *enforceable* right on behalf of mutual funds not to be charged excessive fees by their investment advisers.[30]

Because Congress *supplemented* this existing right of action in 1970, by expressly authorizing mutual fund shareholders to bring such actions "on behalf of" their mutual funds, however,

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[28] *See Burks* v. *Lasker, supra*, 441 U.S. at 478.

[29] The Court of Appeals relied primarily on this Court's decision in *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R. Co., supra*, 213 U.S. at 447, to support its belief that demand is required only if the corporation can assert the same right as the shareholder derivative plaintiff proposes to assert, in an *identical* lawsuit. But, this Court in *Delaware & Hudson* merely acknowledged that a shareholder who has no personal right of action will not be permitted to commence an action on behalf of a corporation unless his suit is founded on *some* right of action possessed by the corporation. *See also*, *Ross* v. *Bernhard, supra*, 396 U.S. at 534-35.

[30] *See, e.g., Levitt* v. *Johnson*, 334 F.2d 815, 816-17 (C.A. 1, 1964), *cert. denied*, 379 U.S. 961 (1965); *Brown* v. *Bullock*, 194 F. Supp. 207 (S.D. N.Y.), *aff'd*, 294 F.2d 415 (C.A. 2, 1961) (*en banc*); *Glicken* v. *Bradford*, 35 F.R.D. 144, 146-47 (S.D. N.Y., 1964); *Acampora* v. *Birkland*, 220 F. Supp. 527, 531-32 (D. Colo., 1963); *Kerner* v. *Crossman*, 211 F. Supp. 397, 398 (S.D. N.Y., 1962); *Report of the Securities and Exchange Comm'n on the Public Policy Implications of Investment Company Growth, reprinted in* H.R. Rep. No. 2337, 89th Cong., 2d Sess. 146 (1966); *Mutual Fund Amendments: Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737, Bills to Amend the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Securities Exchange Act of 1934*, 91st Cong., 1st Sess. 881 (1969) (hereinafter "*1969 House Hearings*"); *Investment Company Amendments Act 1969: Hearings Before the Senate Comm. on Banking and Currency, on S. 34 and S. 296*, 91st Cong., 1st Sess. 30, 421 (1969) (hereinafter "*1969 Senate Hearings*").

the court below held that Congress must have meant to preclude mutual funds from themselves maintaining such actions (A. 32a-33a). 692 F.2d at 255. This reasoning is a *non sequitur*, and worse, it ignores the recent teachings of this Court.

In 1970, Congress carefully reviewed the cases that had confirmed the existence of a mutual fund's enforceable right not to be charged excessive fees, and determined to *strengthen*, not to weaken, that right by expressly authorizing a mutual fund's *shareholders* to maintain such an action in federal court, and by defining the standards applicable to such an action.[31] In doing so, it is both noteworthy and dispositive that Congress did *not* preclude mutual funds from enforcing such rights themselves.[32]

It simply defies logic, and the recent teachings of this Court, therefore, to believe that, having affirmatively endorsed those cases that had implied an enforceable right on behalf of a mutual fund, and having insisted that the express shareholder remedy it was codifying had to be brought "on behalf of" the mutual fund, Congress affirmatively intended to deny mutual funds the ability to vindicate their own rights in their own names.[33]

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[31] *See, e.g.*, H.R. Rep. No. 2337, *supra*, at 132-47; *1969 Senate Hearings*, *supra*, at 420-21; *1969 House Hearings*, *supra*, at 201-02, 260, 439-40; *Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, on H.R. 9510, H.R. 9511, 90th Cong., 1st Sess. 42-43 (1967) (hereinafter "1967 House Hearings")*; *Mutual Fund Legislation of 1967: Hearings Before the Senate Comm. on Banking and Currency on S. 1659*, 90th Cong., 1st Sess. 20, 1016 (1967) (hereinafter "*1967 Senate Hearings*").

[32] *See, e.g.*, *Herman & MacLean* v. *Huddleston*, _____U.S._____, 103 S. Ct. 683, 689 (1983); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353, 102 S. Ct. 1825, 1839 (1982); *Cannon* v. *University of Chicago*, 441 U.S. 677, 694 (1979).

[33] Indeed, application of the four criteria set forth in *Cort* v. *Ash*, 422 U.S. 66, 78 (1975), confirms the propriety of continuing to imply an enforceable right of action by a mutual fund to recover excessive fees. *See Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 934-35; *cf. Grossman* v. *Johnson*, *supra*, 674 F.2d at 120. The court below ignored the tests set forth in *Cort* v. *Ash*, *supra*, 422 U.S. at 78.

The lower court's conclusion—that a shareholder's derivative action under Section 36(b) is somehow not subject to the safeguards normally applicable to all other shareholder derivative suits—is also impossible to square with the genesis, nature and Congressional purposes manifested in the adoption of Section 36(b). Thus, Section 36(b) traces its origins to shareholder actions at common law for corporate waste, which undoubtedly were, and are, derivative within the meaning of Rule 23.1.[34]

By its express terms, Section 36(b) merely defines, for purposes of federal law, what constitutes an actionable breach of fiduciary duty owed to a mutual fund, and it is beyond peradventure of a doubt that a shareholder's action for breach of fiduciary duty is derivative in nature.[35] Section 36(b), accordingly, was not intended to, and most assuredly does not, transform such actions for waste or breach of fiduciary duty from derivative actions to personal claims; rather, the statute was enacted in order to assure the existence of a federal forum, and to articulate federal standards, for the pursuit of this highly traditional derivative cause of action.[36]

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[34] *See, e.g., Smith* v. *Sperling, supra,* 354 U.S. 91; *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 935 & n. 9; *Lewis* v. *Curtis,* 671 F.2d 779 (C.A. 3), *cert. denied,* ____U.S.____, 103 S.Ct. 176 (1982); *Tanzer* v. *Huffines,* 314 F. Supp. 189 (D. Del., 1970); *Saxe* v. *Brady,* 184 A.2d 602 (Del. Ch., 1962); *Brown* v. *Bullock, supra,* 194 F. Supp. 207; H.R. Rep. No. 2337, *supra,* at 132-149; S. Rep. No. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901; H.R. Rep. No. 1382, 91st Cong., 2d Sess. 7 (1970); *1969 House Hearings, supra,* at 794.

[35] *See, e.g., Burks* v. *Lasker, supra,* 441 U.S. at 484; *Koster* v. *(American) Lumbermens Mutual Casualty Co., supra,* 330 U.S. at 522; *Joy* v. *North,* 692 F.2d 880 (C.A. 2, 1982).

[36] *Compare, e.g., Acampora* v. *Birkland, supra,* 220 F. Supp. at 548-49; *and Saxe* v. *Brady, supra,* 184 A.2d at 610; *with Gartenberg* v. *Merrill Lynch Asset Management Fund, Inc.,* 694 F.2d 923, 928 (C.A. 2, 1982); *and Fogel* v. *Chestnutt,* 668 F.2d 100, 111 (C.A. 2, 1981), *cert. denied sub nom., Currier* v. *Fogel,* ____U.S.____, 103 S. Ct. 65, *reh'g denied,* ____U.S.____, 103 S. Ct. 478 (1982); *see generally,* Note, *Mutual Fund Advisory Fees and the New Standard of Fiduciary Duty—Interpreting the 1970 Mutual Fund Act,* 56 Cornell L. Rev. 627 (1971); Comment, *Private Rights of Action Against Mutual Fund Investment Advisers: Amended Section 36 of the 1940 Act,* 120 U. Pa. L. Rev. 143, 158 (1971); *1969 House Hearings, supra,* at 856-58; *1969 Senate Hearings, supra,* at 107, 161-62, 172, 427.

Moreover, even a cursory perusal of the rudiments of a Section 36(b) action demonstrates the derivative nature of the action. A suit under Section 36(b) arises from a contract between the investment company and its investment adviser. The injury alleged is to the mutual fund and, of course, the remedy available to shareholders under Section 36(b) is an equitable one on behalf of the company—an accounting and repayment of excessive fees to the fund.[37]

As in other derivative actions under Rule 23.1, dismissal or settlement of a Section 36(b) action must be approved by the court, generally after notice to other shareholders,[38] and attorneys' fees for successful plaintiffs come from the monies recovered on behalf of the mutual fund.[39] And, the resolution of a shareholder's suit under Section 36(b) is *res judicata*—that is, it effectively ends not only the specific lawsuit involved, it also precludes any other shareholder from commencing or maintaining another action challenging the same advisory fees.[40]

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[37] *See, e.g., In re Gartenberg*, 636 F.2d 16, 18 (C.A. 2, 1980), *cert. denied sub nom., Gartenberg* v. *Pollack*, 451 U.S. 910 (1981); *Markowitz* v. *Moneymart Assets, Inc.*, [1981 Decisions] Fed. Sec. L. Rep. (CCH) ¶98,360 at 92,213 (S.D. N.Y., 1981); *Krasner* v. *Dreyfus Corp.*, 90 F.R.D. 665, 672 (S.D. N.Y., 1981); Note, *Mutual Fund Advisory Fees—Too Much For Too Little?*, 48 Fordham L. Rev. 530, 542 (1980).

[38] *See, e.g., Markowitz* v. *Moneymart Assets, Inc., supra*, [1981 Decisions] Fed. Sec. L. Rep. (CCH) ¶98,360; *Krasner* v. *Dreyfus Corp.*, 500 F. Supp. 36 (S.D. N.Y., 1980); *cf. Ruskay* v. *Waddell*, 552 F.2d 392 (C.A. 2), *cert. denied*, 434 U.S. 911 (1977); *Girsh* v. *Jepson*, 521 F.2d 153 (C.A. 3, 1975); *Newman* v. *Stein*, 464 F.2d 689 (C.A. 2), *cert. denied sub nom., Benson* v. *Newman*, 409 U.S. 1039 (1972); *Norman* v. *McKee*, 431 F.2d 769 (C.A. 9, 1970), *cert. denied sub nom., Isi Corp.* v. *Myers*, 401 U.S. 912 (1971); *Glicken* v. *Bradford, supra*, 35 F.R.D. 144; *Kerner* v. *Crossman, supra*, 211 F. Supp. 397; *see generally*, Annot., 26 A.L.R. Fed. 465 (1976).

[39] *See, e.g., Krasner* v. *Dreyfus Corp., supra*, 90 F.R.D. at 674-75; *cf. Glicken* v. *Bradford, supra*, 35 F.R.D. at 158; *Rome* v. *Archer*, 197 A.2d 49, 57 (Del., 1964).

[40] *See, e.g., Lerner* v. *Reserve Management Co.*, [1981 Decisions] Fed. Sec. L. Rep. (CCH) ¶98,036 (S.D. N.Y., 1981); *cf. Ruskay* v. *Jensen*, 342 F. Supp. 264 (S.D. N.Y., 1972), *aff'd sub nom., Ruskay* v. *Waddell, supra*, 552 F.2d 392; *Rome* v. *Archer, supra*, 197 A.2d at 58; *see generally, Recent Developments*, 45 Fordham L. Rev. 1534, 1540 (1977).

This Court and other courts have acknowledged consistently, and without exception, the derivative nature of a shareholder's action to recover excessive mutual fund advisory fees, both prior [41] and subsequent [42] to the passage of Section 36(b). Put quite simply, until the decision below, no court had ever questioned that an action by a mutual fund shareholder to recover excessive fees and/or for a breach of a fiduciary duty owed to the fund was anything other than derivative.

This consistent judicial recognition of the derivative nature of an action under Section 36(b) is mirrored by the record developed during the Congress' consideration of Section 36(b). That legislative record is replete with references to the derivative character of such a suit.[43] Indeed, at various points during

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[41] *See, e.g., Ross* v. *Bernhard, supra,* 396 U.S. 531; *Kauffman* v. *Dreyfus Fund, Inc.,* 434 F.2d 727 (C.A. 3, 1970), *cert. denied,* 401 U.S. 974 (1971); *Norman* v. *McKee, supra,* 431 F.2d 769, *aff'ing,* 290 F. Supp. 29 (N.D. Cal., 1968); *Levitt* v. *Johnson, supra,* 334 F.2d 815; *Glicken* v. *Bradford, supra,* 35 F.R.D. 144; *Acampora* v. *Birkland, supra,* 220 F. Supp. 527; *Rome* v. *Archer, supra,* 197 A.2d 49; *Saxe* v. *Brady, supra,* 184 A.2d 602; *Meiselman* v. *Eberstadt,* 170 A.2d 720 (Del. Ch., 1961).

[42] *See, e.g., Burks* v. *Lasker, supra,* 441 U.S. 471; *Gartenberg* v. *Merrill Lynch Asset Management, Inc., supra,* 694 F.2d 923; *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d 928; *Grossman* v. *Johnson, supra,* 674 F.2d 115; *Jerozal* v. *Cash Reserve Management, Inc.,* [Current Decisions] Fed. Sec. L. Rep. (CCH) ¶99,019 (S.D. N.Y., 1982); *Blatt* v. *Dean Witter Reynolds Intercapital Inc.,* 528 F. Supp. 1152 (S.D. N.Y., 1982); *Markowitz* v. *Moneymart Assets, Inc., supra,* [1981 Decisions] Fed. Sec. L. Rep. (CCH) ¶98,360; *Markowitz* v. *Brody, supra,* 90 F.R.D. 542; *Krasner* v. *Dreyfus Corp., supra,* 90 F.R.D. 665, 500 F. Supp. 36; *Lerner* v. *Reserve Management Co., supra,* [1981 Decisions] Fed. Sec. L. Rep. (CCH) ¶98,036; *Wolfson* v. *Cooper* [1976 Decisions] Fed. Sec. L. Rep. (CCH) ¶95,634 (S.D. N.Y., 1976); *Boyko* v. *Reserve Fund, Inc.* 68 F.R.D. 692 (S.D. N.Y., 1975).

[43] *See, e.g.,* H.R. Rep. No. 1382, *supra,* at 78, 83; *1969 House Hearings, supra,* at 202; *1969 Senate Hearings, supra,* at 156; *1967 House Hearings, supra,* at 42; 116 Cong. Rec. 33,286-87 (1970); *see also 1969 House Hearings, supra,* at 796-98 (Testimony of Judge Henry J. Friendly); *1969 Senate Hearings, supra,* at 185, 420-21.

So universal was the acknowledgment that an action under Section 36(b) would be derivative, that the late Abraham Pomerantz, with whom the plaintiff's attorney in this action practiced law for many years, testified:

> Mr. Pomerantz. Perhaps I should say at the outset that . . . over the past decade I have been quite preoccupied with my associate.

(footnote continues)

the legislative deliberations leading to the adoption of Section 36(b), various members of Congress expressed concern about the potential abuses that might inhere in the creation of an express shareholder derivative action; *Section 36(b) was adopted only after Congress was satisfied that the Federal Rules of Civil Procedure generally, and the provisions of Rule 23.1 in particular, would minimize the danger of so-called strike suits.*[44]

C. Application Of The Demand Requirement To Actions Under Section 36(b) Is Necessary To Effectuate The Purposes Of The Investment Company Act.

The Court of Appeals predicated its decision upon its belief that requiring adherence to the demand requirement would *never* be a productive exercise (A. 41a). 692 F.2d at 259. Despite the fact that Congress went to great lengths in 1970 to reinforce the obligations and powers of the independent directors of an investment company—efforts noted with great approval by this Court just a few years ago, in ***Burks*** v. ***Lasker, supra,*** 441 U.S. at 483-85—the Court of Appeals denigrated Congress' efforts, stating that they "cannot seriously be expected" to achieve their intended result (A. 41a). 692 F.2d at 259.

The 1970 Amendments to the Investment Company Act, however, were intended, as this Court has observed, "to strengthen . . . the independence of" the outside directors of investment companies. ***Burks*** v. ***Lasker, supra,*** 441 U.S. at 482. As this Court there noted:

> [T]he structure and purpose of the Investment Company Act indicated that Congress entrusted to the

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(footnote continued)

> Richard Mayer [sic], in bringing derivative actions on behalf of mutual funds against their respective advisers and managers . . . . [*T*]*he law says to us that if you represent a shareholder of a fund, the action that you bring, the derivative action is indeed brought "on behalf of the corporation involved."*

1969 House Hearings, supra, at 765-66 (emphasis supplied).

[44] *See, e.g., 1969 House Hearings, supra,* at 149, 201, 860; *1969 Senate Hearings, supra,* at 30, 156; H.R. Rep. No. 1382, *supra,* at 64.

> independent directors of investment companies, . . . the *primary* responsibility for looking after the interests of the funds' shareholders.

441 U.S. at 484-85 (emphasis supplied).

Nothing in Section 36(b) compels a different conclusion. As the legislative history of that section manifests, Congress most assuredly did not intend to weaken or denigrate the powers of the independent directors of a mutual fund to act in the best interests of the fund's shareholders, and in accordance with state law:

> [Section 36(b)] is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company . . . from the directors . . . to the judiciary.

S. Rep. No. 184, *supra,* at 4903.

The decision below is, therefore, diametrically inconsistent with the carefully-enacted statutory scheme of the ICA. Section 10 of the Act requires a certain percentage of disinterested board members of an investment company. 15 U.S.C. § 80a-10. Pursuant to Section 15, those board members are entrusted with certain, critical, supervisory functions, including review, approval and, if necessary, termination, of underwriter and advisory contracts. 15 U.S.C. § 80a-15.

In carrying out these functions, the directors must request and study all information necessary to their evaluation of such contracts. 15 U.S.C. § 80a-15(c). As with all other corporate directors, investment company directors are forbidden from engaging in actions or practices which constitute a breach of fiduciary duty involving personal misconduct. 15 U.S.C. § 80a-35.

The Second Circuit's opinion ignores these Congressionally-delegated responsibilites by repudiating the demand requirement and bypassing director participation in matters of crucial interest to a mutual fund. It justified this result by asserting that a mutual fund's independent directors can *never* be truly independent (A. 41a-46a). 692 F.2d at 259-61. The decision below thus evidences the utmost cynicism; in effect, the Court of Appeals dispensed with demand because, *in its view*, independent directors will *never* exercise independent judgment, and shareholders can *never* be persuaded that litigation may not be in their funds' best interests. These notions, which are contrary to Congress' design, were effectively dispelled by this Court in *Burks* v. *Lasker*:

> [T]he Court of Appeals [for the Second Circuit] was also of the view that mutual fund directors can never be truly disinterested .... While lack of impartiality may or may not be true as a matter of fact in individual cases, it is not a conclusion of law required by the Investment Company Act. Congress surely would not have entrusted such critical functions as approval of advisory contracts and selection of accountants to the statutorily disinterested directors had it shared the Court of Appeals' view that such directors could never be "disinterested" where their codirectors or investment advisers were concerned.

441 U.S. at 485 n. 15.

The capacity of a mutual fund's independent directors to perform the "host of special responsibilities" Congress has assigned them [45] is seriously undermined by a holding that a mutual fund shareholder need *never* comply with the demand requirement embodied in Rule 23.1 prior to bringing a formal complaint regarding excessive fees under an advisory contract.

Quite to the contrary, upon early notice of such a grievance—through shareholder demand—a mutual fund's board of directors can seek to obtain a beneficial resolution of the

[45] *Burks* v. *Lasker*, *supra*, 441 U.S. at 483.

dispute, if the dispute is real. Indeed, the directors, through the contractual leverage of the Act's prescriptions, may very well be able to obtain a more satisfactory settlement than the judgment permitted under the one-year fee recovery limitation set forth in Section 36(b).[46]

As summarized by the court in *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 942 n. 16, mutual fund directors can respond to a timely demand by a shareholder in a variety of ways, including:

> (1) negotiating a rebate of fees, (2) satisfying the shareholder that the fees are reasonable in terms of the investment services provided, (3) persuading the shareholder that litigation would adversely affect shareholders' interests, (4) accepting the demand and instituting suit, or (5) refusing the demand.

When weighed against the above-described benefits, it is difficult to comprehend what burdens a mutual fund shareholder will suffer by complying with the demand requirement.[47]

In short, as this Court noted in *Burks* v. *Lasker, supra,* 441 U.S. at 485:

> It would have been paradoxical for Congress to have been willing to rely largely upon [a mutual fund's independent directors] as "watchdogs" to protect shareholder interests and yet, where the "watchdogs" [seek to do] precisely that, require that they be totally muzzled.

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[46] *See* p. 3, n. 4, *supra.*

[47] The Court of Appeals suggested, without citation, that the delay caused by the demand process might preclude a full recovery of excessive fees in certain cases because of the one-year limitation on fee recoveries contained in Section 36(b)(3) (A. 47a-48a). 692 F.2d at 261-62. But, such a concern is unrealistic. Courts commonly accept limitations upon the time in which a board of directors must respond to a demand. If the board fails to act within a reasonable period of time, the shareholder is free to proceed with the litigation. *See, e.g., Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 938; *Grossman* v. *Johnson, supra,* 674 F.2d at 122; *Mills* v. *Esmark, Inc.,* 91 F.R.D. 70 (N.D. Ill., 1981); *Zilker* v. *Klein,* 510 F. Supp. 1070 (N.D. Ill., 1981).

Just as in *Burks* v. *Lasker*, the decision of the court below would render the independent directors of the Fund "totally muzzled." In painstakingly enacting and amending the Investment Company Act, Congress never intended such a result.[48]

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[48] The Court of Appeals justified its departure from the teachings of this Court in *Burks* v. *Lasker*, by relying upon the *dictum* in that decision that the independent directors of a mutual fund might not be able to terminate a derivative action brought pursuant to Section 36(b) (A. 46a). 692 F.2d at 261, *quoting*, 441 U.S. at 484.

It is not clear that independent mutual fund directors lack the ability to terminate Section 36(b) actions. This Court, in assuming (without deciding) that Congress intended to prevent director termination of such suits, relied upon the language of Section 36(b)(2): that section instructs federal courts to give appropriate consideration to the fact that a challenged advisory contract was approved by a mutual fund's board of directors or ratified by the fund's shareholders. The legislative history of that section demonstrates, however, that Congress was not concerned with director dismissal of a shareholder derivative action *after* demand; rather, Congress intended to preclude automatic judicial dismissal of such an action (absent proof of waste) on the ground that the advisory contract in question had, *prior* to becoming effective, been approved by the board or ratified by shareholders pursuant to ICA Section 15. *See, e.g.*, S. Rep. No. 184, *supra*, at 4910; H.R. Rep. No. 1382, *supra*, at 37; *1969 House Hearings*, *supra*, at 696, 784-89; *1967 House Hearings*, *supra*, at 43, 105-06; H.R. Rep. No. 2337, *supra*, at 145-46; *1967 Senate Hearings*, *supra*, at 21.

Even if independent directors cannot automatically terminate a Section 36(b) action, however, the demand requirement, and its salutory purposes, still serve the important public policies discussed in the text above. *See, e.g.*, *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 940-41; *Grossman* v. *Johnson*, *supra*, 674 F.2d at 121.

CONCLUSION

For the foregoing reasons, the decision of the Court of Appeals should be reversed.

Respectfully submitted,

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April 21, 1983

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No. 82-1200

In the Supreme Court of the United States

OCTOBER TERM, 1982

DAILY INCOME FUND, INC. AND
REICH & TANG, INC., PETITIONERS

v.

MARTIN FOX

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE IN SUPPORT OF AFFIRMANCE

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QUESTION PRESENTED

Whether an investment company security holder must make a demand upon that company's board of directors prior to initiating an action under Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-35(b), challenging the compensation paid to the company's investment adviser.

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

Congress has given the Securities and Exchange Commission responsibility for enforcing the federal securities laws, including the Investment Company Act of 1940 ("the Act"), 15 U.S.C. (& Supp. V) 80a-1 *et seq.* A major purpose of the Act is to protect investment company security holders against harm resulting from the conflicting interests of the company's directors and investment adviser, on the one hand, and its security holders, on the other. One common abuse resulting from such conflicts concerns the compensation paid to the company's investment adviser.

Section 36(b) of the Act, 15 U.S.C. 80a-35(b), the statutory provision at issue in this case, grants security holders and the Commission the right to sue investment advisers in order to recover excessive fees. Security holder suits under Section 36(b) provide a necessary supplement to the Commission's own enforcement authority under this Section. Cf. *Mills* v. *Electric Auto-lite Co.*, 396 U.S. 375, 382 (1970); *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964).

The Commission believes that a requirement of prelitigation demand on directors in security holder actions under Section 36(b) would serve no meaningful purpose and could frustrate full recovery of excessive fees because of delays necessarily associated with demand. Furthermore, if this Court should hold that a director demand requirement applies in such actions, it is important, in the Commission's view, that the directors' refusal to pursue a claim not restrict a security holder's right to institute and maintain suit. Any such restriction would undermine the effectiveness of security holder actions and would place an undue burden on the Commission's limited enforcement resources.

STATEMENT

Respondent Martin Fox, a security holder of petitioner Daily Income Fund, Inc., a registered investment company, brought suit pursuant to Section 36(b) of the Investment Company Act of 1940 in the United States District Court for the Southern District of New York, seeking recovery on the Fund's behalf of allegedly excessive advisory fees paid by the Fund to its investment adviser, petitioner Reich & Tang, Inc. ("R&T"). The complaint alleged that R&T had breached its fiduciary duty to the Fund with respect to receipt of compensation because its fee was based upon a fixed percentage of the assets under management and did not take into account economies of scale realized when the size of the Fund substantially increased. The complaint stated that R&T's annual man-

agement fee amounted to one-half of one per cent of the Fund's net assets, which rose from approximately $75 million in 1978 to approximately $775 million in 1981. As a consequence, the complaint noted, during the year preceding the filing of the complaint, R&T's fee increased from approximately $2 million to $4 million. The complaint alleged that these fees were "excessive" and "exorbitant" in view of the "routine and administrative" nature of the services that R&T rendered to the Fund. J.A. 5a-8a.

The plaintiff recited that he had not made demand on the Fund or its directors to institute this action because no such demand is required under Section 36(b). In addition, the complaint alleged that the directors' prosecution of any Section 36(b) claim against R&T would be "hostile" to the suit's success since all of the directors were dependent on R&T for their positions and all had participated in establishing R&T's fees.

The district court dismissed the complaint on the basis of Fed. R. Civ. P. 23.1 because the plaintiff had not made a prelitigation demand upon the board of directors (J.A. 20a). The court found that plaintiff had not pleaded sufficient self-interest or bias on the part of the investment company's disinterested directors to excuse demand in this case (*id.* at 21a). The court of appeals (Kaufman, Feinberg, Friendly, JJ.) reversed, finding that actions under Section 36(b) are not subject to a demand requirement. Observing (J.A. 28a; footnote omitted) that "the Rule 23.1 demand requirement applies only when a corporation or association has 'failed to enforce a right which may properly be asserted by it,' " the court concluded that no such requirement applies to Section 36(b) actions because the language of that provision and the legislative history of the Investment Company Act of 1940 show that Congress did not create a corporate right of action (J.A. 30a-46a). The court also noted that, because of the distinctive nature of the Section 36(b) action, there is no policy reason for imposing a demand requirement (J.A. 46a-48a).

SUMMARY OF ARGUMENT

The court of appeals correctly concluded that an investment company security holder who brings suit under Section 36(b) of the Investment Company Act of 1940 to challenge the compensation paid to the company's investment adviser need not make demand upon the company's board of directors before filing his action.

1. Petitioners and the two courts of appeals that have required such demand have proceeded from the erroneous premise that Fed. R. Civ. P. 23.1 imposes a demand requirement. In fact, however, Rule 23.1 merely requires a derivative suit plaintiff to plead whether demand was made and, if not, why. As a rule of procedure, Rule 23.1 does not and indeed cannot impose a demand requirement. Rather, the traditional demand requirement applicable to derivative actions is a principle of substantive state corporation law. The issue in this case, therefore, is whether the demand requirement traditionally imposed in derivative suits is consistent with the unique private cause of action created by Section 36(b).

2. That prelitigation demand is not required in security holder actions under Section 36(b) is apparent from the abuses that led to its enactment, the nature of the cause of action, and the purposes served by the traditional demand requirement.

a. Congress's reason for creating the Section 36(b) security holder suit is fundamentally inconsistent with the underlying rationale of the traditional demand requirement. The demand requirement gives effect to the principle that ordinarily a corporation, through its directors, is capable of controlling its own affairs, including matters relating to litigation. Section 36(b), in contrast, reflects a congressional determination that, due to conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors.

A major impetus for the 1970 Amendments to the Investment Company Act of 1940 (Pub. L. No. 91-547, 84 Stat. 1413 *et seq.*), which added Section 36(b), was the inadequate recourse available under state law to an investment company security holder seeking to challenge the fairness of compensation arrangements between the company and its investment adviser. The judicial deference ordinarily given directors' business judgment in approving such contracts had insulated them from judicial review except where corporate waste could be shown. Section 36(b) was enacted to provide security holders with a federal remedy free from such strictures of state law. In particular, Section 36(b)(2) of the Act, 15 U.S.C. 80a-35(b)(2), expressly limits the weight to be accorded the business judgment of the directors to that which a court deems appropriate.

b. The demand requirement has relevance only in the true derivative situation, since it affords the corporation the initial opportunity to pursue its claim. Where the corporation has no right of action, demand has no place. By its terms, Section 36(b) grants no cause of action to the investment company, but instead authorizes suits only by the Commission and security holders. And no cause of action should be implied in favor of the investment company. Congress expressly rejected proposals to permit investment companies to bring suit under Section 36(b). Congress concluded, based upon detailed studies chronicling a long history of abuses, that investment company participation in advisory fee litigation would be of little or no benefit, if not actually counterproductive.

The fact that security holder actions under Section 36(b) are brought "on behalf of" the investment company does not mean that such suits are true derivative actions. Rather, that language merely signifies that recovery must be paid to the company rather than to the individual security holder plaintiff. Nor does that language mean that the company itself may sue. Security holders who file actions under Section 36(b) do not assert a claim derived from the company, but act as "private attorneys general" in enforcing that provision.

c. The demand requirement would serve no meaningful purpose and would frustrate full recovery. In the usual derivative situation, demand affords the corporation's directors an opportunity to consider the transaction at issue, to ratify the challenged corporate action, or to move to block the suit on the ground that it is contrary to the corporation's best interests. In contrast, under the Investment Company Act of 1940, the directors will already have considered the fairness of fee arrangements since they are obligated by statute to do so. Furthermore, while demand ordinarily provides an opportunity for directors to ratify the challenged transaction, thereby restricting the scope of judicial review, Section 36(b)(2) expressly limits the weight to be accorded to the directors' approval of an advisory fee contract. Finally, as this Court observed (*Burks* v. *Lasker*, 441 U.S. 471, 484 (1979)), investment companies may not cut off security holder actions brought pursuant to Section 36(b).

In an effort to show that prelitigation demand would serve some purpose in Section 36(b) suits, petitioners suggest that it might encourage out of court settlements, but that suggestion ignores the special characteristics of Section 36(b) litigation. In traditional derivative suits, demand may bring to the directors' attention claims of which they were previously unaware or that they did not fully appreciate. The corporation, which may itself assert those claims, can then effectively negotiate with prospective defendants. By contrast, in a Section 36(b) suit, demand will not alert the directors to new claims, since they are required by statute to evaluate the fairness of and approve advisory fees. And since the investment company may not sue under Section 36(b), it is in a poor position to negotiate a settlement.

While requiring prelitigation demand would serve little useful purpose, it could have serious detrimental consequences, especially because recovery under Section 36(b) is limited to the actual damages suffered beginning one year prior to the filing of suit (Section 36(b)(3), 15

U.S.C. 80a-35(b)(3)). A demand requirement would necessarily delay institution of suit, thereby insulating some excessive advisory fees from judicial redress.

3. If this Court should hold that prelitigation demand is required in Section 36(b) actions, we urge the Court to reaffirm its statement in *Burks* v. *Lasker*, *supra*, 441 U.S. at 484, that investment company management cannot block or hobble such actions. Management interference with security holder actions would place an increased enforcement burden on the Commission and would harm the interests of investment company security holders.

ARGUMENT

I. A SECURITY HOLDER WHO BRINGS SUIT UNDER SECTION 36(b) OF THE INVESTMENT COMPANY ACT OF 1940 TO CHALLENGE THE FAIRNESS OF THE COMPENSATION PAID TO THE COMPANY'S INVESTMENT ADVISER NEED NOT MAKE A PRELITIGATION DEMAND UPON THE COMPANY'S BOARD OF DIRECTORS

A. Fed. R. Civ. P. 23.1 is simply a rule of pleading and does not impose a demand requirement

Both petitioners (Br. 5-9) and the two courts of appeals that have required prelitigation demand in Section 36(b) security holder suits (see *Weiss* v. *Temporary Investment Fund, Inc.*, 692 F.2d 928, 930, 936 (3d Cir. 1982), petition for cert. pending, No. 82-1592; *Grossman* v. *Johnson*, 674 F.2d 115, 118-120 (1st Cir. 1982), cert. denied, No. 81-2361 (Oct. 4, 1982)), have assumed that Fed. R. Civ. P. 23.1 itself imposes a demand requirement. This premise is contrary to the language of the rule and would convert what is merely a pleading requirement into a substantive rule of federal law.

By its terms, Rule 23.1 does not require that demand be made upon the corporation's board of directors, but only that "[t]he complaint *shall* * * * *allege* with particularity the efforts, *if any*, made by the plaintiff to obtain the action he desires from the directors or com-

parable authority * * * and the reasons for his failure to obtain the action or for not making the effort" (emphasis added).[1] In this case, plaintiff satisfied this provision by pleading with sufficient particularity that he had not made a demand because it is not necessary to do so in Section 36(b) actions.

If Rule 23.1 imposed a substantive demand requirement, it would violate 28 U.S.C. 2072, which provides that rules of civil procedure may not "abridge, enlarge or modify any substantive right." See *Mississippi Publishing Corp.* v. *Murphree*, 326 U.S. 438, 445-446 (1946); *Sibbach* v. *Wilson & Co.*, 312 U.S. 1, 14 (1941). This Court has recognized that Rule 23.1 "neither create[s] nor exempt[s] from liabilities, but require[s] complete disclosure to the court and notice to the parties in interest." *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541, 556 (1949). The issue in this case, then, is not whether demand is required by Rule 23.1 but whether the traditional demand requirement of state corporation law is "consistent" with the cause of action created by Section 36(b). See *Burks* v. *Lasker*, *supra*, 441 U.S. at 479; *Johnson* v. *Railway Express Agency*, 421 U.S. 454, 465 (1975); *Sola Electric Co.* v. *Jefferson Co.*, 317 U.S. 173, 176 (1942).

B. Requiring prelitigation demand in security holder actions under Section 36(b) would be inconsistent with that unique cause of action

When Congress enacted Section 36(b) in 1970 (Pub. L. No. 91-547, Section 20, 84 Stat. 1428), it created a unique federal cause of action that departed from the pattern of the typical derivative suit. It is apparent from the nature of that cause of action, its legislative history, and the purposes served by the traditional demand requirement that prelitigation demand is not required under Section 36(b).

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[1] Rule 23.1 likewise does not prescribe the consequences that flow from the failure to make a demand or the circumstances in which demand may be excused.

1. *Congress's reason for creating security holder actions under Section 36(b) is contrary to the rationale for the prelitigation demand requirement*

Resolution of the director demand issue presented by this case requires an understanding of the dramatically different purposes served by the demand requirement traditionally applicable in derivative suits and the unique cause of action conferred upon security holders by Section 36(b). The demand requirement gives effect to the principle that corporations, acting through their boards of directors, are ordinarily capable of controlling their own affairs, including matters relating to litigation. *Delaware & Hudson Co.* v. *Albany & S. R.R.*, 213 U.S. 435, 446 (1909); *Hawes* v. *City of Oakland*, 104 U.S. 450, 457 (1882). Because courts are reluctant to interfere with directors' business judgments, a corporate decision to forego litigation, like other business decisions, is ordinarily honored. See *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261, 263-264 (1917).

Section 36(b), by contrast, reflects a congressional determination that, due to conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors. Thus, Congress's reason for creating the Section 36(b) security holder action is fundamentally inconsistent with the underlying rationale of the traditional demand requirement.

Flagrant abuses in the investment company industry prompted enactment of the Investment Company Act of 1940 and, later, Section 36(b). We review briefly the relevant industry abuses and the legislative provisions designed to remedy them.

a. An investment company is a pool of liquid assets owned by its security holders. As usually structured, an investment company is controlled by a separate entity, commonly called an investment adviser. The adviser typically organizes and promotes the investment company,

provides management services, selects the company's investments, handles sales of the company's shares through an associated underwriter, and supervises the business operations of the company. Persons affiliated with the adviser usually serve on the board of directors of the investment company. Thus, the adviser of an investment company typically exercises at least as much control over the company as internal management does in other corporations. This method of organization causes special problems. Although the primary goal of management should be to maximize the corporation's profits and thus the return to its investors, an investment adviser is also motivated by a desire to maximize its own profits. See *Burks* v. *Lasker, supra*, 441 U.S. at 480-481; *Tannenbaum* v. *Zeller*, 552 F.2d 402, 405 (2d Cir.), cert. denied, 434 U.S. 934 (1977); S. Rep. No. 91-184, 91st Cong., 1st Sess. 5 (1969).

Enactment of the Investment Company Act of 1940 was prompted, in large part, by abuses arising from such conflicts of interest. In its *Report on the Study of Investment Trusts and Investment Companies*, H.R. Doc. No. 279, (Pt. 3), 76th Cong., 1st Sess. 1-2483 (1939), the Securities and Exchange Commission identified these abuses as including self-dealing, larceny, and embezzlement by investment company management. See also S. Rep. No. 1775, 76th Cong., 3d Sess. 6-8 (1940). After receiving this report, Congress concluded that the public interest was adversely affected when investment companies were managed "in the interest of directors, officers, [or] investment advisers * * * rather than in the interest of * * * security holders." Section 1(b)(2), 15 U.S.C. 80a-1(b)(2). The Investment Company Act of 1940 was intended to "mitigate and, so far as is feasible, * * * eliminate * * * conditions * * * which adversely affect the national public interest and the interest of investors." Section 1(b), 15 U.S.C. 80a-1(b).

To combat these abuses, Congress created a regulatory scheme that imposed some controls on company manage-

ment but did not eliminate the dominance of investment companies by their advisers. See *United States* v. *National Association of Securities Dealers, Inc.*, 422 U.S. 694, 704-705 & n.13 (1975). In the area of investment adviser compensation, the Act provided a "few elementary safeguards" designed to prevent abuses. *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess., Pt. 1, 251-252 (1940) (Statement of David Schenker, Chief Counsel, SEC Investment Trust Study); *Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., Pt. 1, 3 (1967) (Statement of Manual F. Cohen, Chairman, SEC) (hereinafter cited as "*1967 S. Hearings*"). At least 40% of the directors were required to be persons other than officers or employees of the company or persons "affiliated" [2] with its adviser. Act of Aug. 22, 1940, ch. 686, Title I, Section 10(a), 54 Stat. 806. Congress intended for these directors to "furnish an independent check upon the management" of investment companies. *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 109 (1940). In addition, initial approval of the advisory fee contract was vested in the majority of outstanding voting security holders, and the board of directors or security holders were required to approve annually any continuation of the contract beyond two years. Section 15(a), 15 U.S.C. 80a-15(a). Finally, any renewal of the contract was required to be approved by a majority of either the unaffiliated directors or the holders of the outstanding shares. Section 15(c) of the Act of Aug. 22, 1940 (54 Stat. 813).

[2] For the definition of "[a]ffiliated person," see Section 2(a)(3) of the Act, 15 U.S.C. 80a-2(a)(3).

b. Dramatic growth in the size of mutual funds during the 1950's and 1960's prompted the Commission to authorize two studies of the investment company industry.[3] Of particular concern to the Commission was whether, as investment companies' assets grew, economies of scale in management costs were being passed on to the individual investors.[4] As stated at hearings in 1969, "it does not cost 10 times as much to manage a $1 billion fund as it costs to manage a $100 million fund." *Investment Company Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong., 1st Sess. 9 (1969) (Statement of Hugh F. Owens, Commissioner, SEC) (hereinafter cited as "*1969 S. Hearings*"). See also *id.* at 17; S. Rep. No. 91-184, *supra*, at 6; *SEC Report on Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 10-11 (1966).

In 1958, the securities research unit of the Wharton School of Finance and Commerce of the University of Pennsylvania commenced a Commission-authorized study on the effects of growth in the mutual fund industry. The resulting Wharton Report, which was transmitted to Congress in 1962, found that investment advisers tended to charge mutual funds "substantially higher" rates than they charged other clients. *Wharton School*

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[3] In 1940, Congress had recognized the potential for future problems in the industry and had authorized the Commission to conduct studies, report the results of its investigations, and make recommendations if "any substantial further increase in size of investment companies create[d] any problem involving the protection of investors or the public interest * * *." Section 14(b), 15 U.S.C. 80a-14(b).

[4] From 1940 to 1969, the net assets of the mutual fund industry grew from one half billion dollars to over $50 billion. By September 30, 1982, the industry's net assets had reached more than $281 billion. 1982 SEC Ann. Rep. 96.

Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 29 (1962). The report stated that the prevalent practice in the industry was to calculate advisory fees on the basis of a fixed percentage of assets managed, rather than on services rendered or actual expenses (*id.* at 28-29). The report concluded that mutual funds lacked effective bargaining power in the establishment of advisory fee rates because they were, in essence, "legal shells" dependent on their external investment advisers (*id.* at 30, 66-67). The report also found unaffiliated directors to be "of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser" (*id.* at 34).

The Wharton Report made no legislative recommendations, and accordingly, when the Commission transmitted that report to Congress, the Commission stated that it would evaluate the public policy questions raised and would itself report to Congress at a later time. In 1966, the Commission issued a Report on the Public Policy Implications of Investment Company Growth, and that report found that lawsuits by security holders challenging excessive advisory fees had been largely fruitless. H.R. Rep. No. 2337, *supra*, at 128-130. The report found that the existing provisions of the Investment Company Act of 1940 concerning approval of advisory fee contracts had not only failed to serve as an effective check on management but had proven detrimental to shareholders who attempted to challenge advisory fees. H.R. Rep. No. 2337, *supra*, at 142. The report noted that courts would generally review the fairness or reasonableness of corporate transactions in which a director has a personal interest. But the report found that in the three litigated cases challenging the fairness of mutual fund advisory fee agreements, the courts had pointed to the approval of those contracts by the security holders or unaffiliated directors and had therefore changed the applicable standard from simple fairness or reasonableness

to the much more permissive standard of waste of corporate assets. *Acampora* v. *Birkland*, 220 F. Supp. 527, 548-549 (D. Colo. 1963); *Saxe* v. *Brady*, 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (1962); *Meiselman* v. *Eberstadt*, 39 Del. Ch. 563, 568, 170 A.2d 720, 723 (1961).[5] Thus the very protection created by Congress to prevent unfair fee agreements had been transformed into an instrument to avoid judicial scrutiny of those contracts.

c. To remedy these inadequacies, the Commission submitted to Congress a series of legislative proposals that resulted in the 1970 Amendments to the Act. These amendments sought to curb abuses relating to advisory fee contracts in essentially two ways. First, the investment company board was made more independent and was given a greater role in approving advisory fee agreements. Section 10(a), 15 U.S.C. 80a-10(a), was amended to require that at least 40% of the directors not be "interested persons," a category broader than that to which the same proscription had previously applied. See Section 2(a)(19), 15 U.S.C. 80a-2(a)(19). Congress retained the provisions requiring that shareholders initially approve any advisory contract and that any continuance beyond two years be approved by the board of directors or the shareholders. Section 15(a)(2), 15 U.S.C. 80a-15(a)(2). In addition, Section 15(c), 15 U.S.C. 80a-15(c), was amended to place independent responsibility on the disinterested directors to approve any advisory contract. Congress also imposed an obligation on these directors to request and evaluate—and a correlative duty on investment advisers to furnish—information relevant to an assessment of the contract (*ibid.*).

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[5] Similar obstacles had been encountered by security holders who challenged the fairness of advisory fees under provisions of the Investment Company Act of 1940. Litigants who sought relief under former Section 36, Act of Aug. 22, 1940, ch. 686, Title I, 54 Stat. 841, were required to prove gross abuse of trust. See *Brown* v. *Bullock*, 194 F. Supp. 207 (S.D.N.Y. 1961), aff'd, 294 F.2d 415 (2d Cir. 1961). See *1969 S. Hearings*, *supra*, at 30; *1967 S. Hearings*, *supra*, at 117-118.

Congress was not content, however, to rely solely upon the strengthened independence of the board of directors. It recognized that even the disinterested directors could not be relied upon fully to protect the security holders' interests in matters concerning advisory compensation. Accordingly, a new cause of action was created that allowed security holders to test the fairness of advisory fee contracts without encountering some of the chief stumbling blocks that had characterized prior litigation. Whereas security holders who challenged such contracts had previously been required to prove corporate waste, Section 36(b) imposes a fiduciary duty on the investment adviser with respect to receipt of compensation from the investment company. Moreover, this section authorizes the Commission, as well as individual security holders acting on the company's behalf, to institute an action for breach of that duty. When a security holder institutes suit under that provision, the Commission is authorized to intervene. Section 44, 15 U.S.C. 80a-43. In a marked departure from prior law, the statute provides that any approval of the advisory contract by the board of directors or shareholders of the investment company should be given only "such consideration by the court as is deemed appropriate under all the circumstances." Section 36(b)(2), 15 U.S.C. 80a-35(b)(2). The Senate Report noted that some consideration was due management's judgment regarding the fairness of the fee but emphasized that "such consideration would not be controlling in determining whether or not the fee encompassed a breach of fiduciary duty." S. Rep. No. 91-184, *supra*, at 15.

While creating this potent new remedy, Congress did impose certain significant restrictions. Liability is imposed only upon the recipients of compensation and may not exceed the amount of compensation received. Furthermore, damages may not be recovered for any period prior to one year before institution of the action. Section 36(b)(3), 15 U.S.C. 80a-35(b)(3).

2. *Congress's decision not to authorize investment company suits under Section 36(b) is inconsistent with a prelitigation demand requirement in security holder actions under that provision*

The demand requirement has relevance only in the true derivative situation in which the shareholder asserts a claim that is "not his own but the corporation's." *Koster* v. *Lumbermen's Mutual Casualty Co.*, 330 U.S. 518, 522 (1947) (footnote omitted). See *Price* v. *Gurney*, 324 U.S. 100, 105 (1945); *Delaware & Hudson Co.* v. *Albany & S. R.R.*, *supra*, 213 U.S. at 447. Demand thus affords the corporation the opportunity to proceed on its own behalf if it chooses to do so. Accordingly, since an investment company may not itself bring suit under Section 36(b), the chief reason for prelitigation demand is absent. Moreover, Congress's deliberate decision not to authorize investment company suits indicates a strong congressional belief that the company's participation in litigation concerning the reasonableness of advisory fees would be of little or no benefit, if not actually counterproductive. As the court below aptly put it (J.A. 44a-45a): "The relationship of a Fund to its adviser makes it a part of the problem in a way that precludes it from being part of the solution, at least at the litigation stage." [6]

a. Petitioners (Br. 9-14) and the courts of appeals that have required prelitigation demand in cases such as this (*Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 934-935; *Grossman* v. *Johnson*, *supra*, 674 F.2d at 120) maintain that an investment company has an im-

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[6] It is irrelevant that an investment company may challenge an excessive advisory fee by asserting a state claim for corporate waste (compare Pet. Br. 15-16; Investment Company Institute Amicus Br. 13-15). As we have noted, Congress enacted Section 36(b) in large measure because corporate waste actions had proven ineffective as a remedy for excessive advisory fees. It is therefore untenable to suggest that Congress intended to require prelitigation demand, which would delay institution of potentially efficacious Section 36(b) suits, in order to permit the investment company to prosecute a suit for corporate waste.

plied cause of action under Section 36(b). That argument, however, flies in the face of the statutory language and the legislative history.

This Court has recognized that the central inquiry in determining whether a private right of action should be implied is congressional intent. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353, 377-378 (1982); *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 15-16 (1979). And of course, the starting place for determining that intent is the language of the statute. See, *e.g.*, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976).

In this case, the statutory language speaks with particular clarity. Section 36(b) expressly authorizes suit by security holders and the Commission but makes no mention of actions by investment companies. Thus, on the face of the statute, it is difficult to conclude that Congress intended to authorize investment company suits but simply neglected to say so expressly.[7]

At all events, the legislative history of the provision refutes any such conjecture. The fact is that Congress specifically considered and rejected a proposal that would have allowed investment companies themselves to sue, as well as another proposal that would have expressly made the security holder action derivative in nature.

The bill originally proposed by the Commission contemplated that the Commission could sue to enforce the suggested reasonable compensation requirement under its

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[7] Whether an investment company has an implied right of action under Section 36(b) is of course distinct from the question whether there may be implied remedies under other provisions of the Investment Company Act of 1940. In enacting Section 36(b), Congress clearly did not intend to preempt implied remedies under other provisions of the Act. Both the Senate and House Reports on the 1970 Amendments state: "[a]lthough section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a)." S. Rep. No. 91-184, *supra*, at 16; H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 38 (1970).

existing statutory enforcement authority. That bill did not expressly authorize private suits, but it contained references to "damage" actions and gave the Commission authority to intervene in any action brought "by or on behalf of a registered investment company." S. 1659, 90th Cong., 1st Sess. §§ 8(d), 23 (1967); *1967 S. Hearings*, *supra*, at 45. It therefore appears to have assumed that such actions could be brought both by investment companies and their shareholders.

The investment company industry opposed giving the Commission the authority to enforce the fairness of advisory contracts for fear that such power would be tantamount to rate-making authority. *1967 S. Hearings*, *supra*, at 197. The industry therefore proposed that actions to enforce the fairness standard "be brought only by the company or a security holder thereof on its behalf * * *." *Id.* at 100-101. As a result of these and other objections, a revised bill was passed by the Senate in July 1968. S. 3724, 90th Cong., 2d Sess. (1968). That bill rejected the industry's objection to Commission suits. It required a security holder to make demand on the Commission before filing suit. And if the Commission refused or failed to bring suit within six months, the bill provided that the security holder could maintain an action in a "derivative" or representative capacity. S. 3724, 90th Cong., 2d Sess. § 8(d)(6) (1968). The industry's suggestion that the investment company itself be expressly authorized to sue was rejected. The bill, however, retained the provision allowing the Commission to intervene in any action brought by the company or by a security holder on its behalf. S. 3724, 90th Cong., 2d Sess. § 22 (1968).

This bill was reintroduced in the 91st Congress. Following further hearings and discussions between representatives of the Commission and the industry, the present version of Section 36(b) was drafted and enacted. See S. 2224, 91st Cong., 1st Sess. § 20(b) (1969); 115 Cong. Rec. 13648 (1969) (Statement of Sen. McIntyre). The specific reference in the prior version to the deriva-

tive or representative nature of the security holder action was eliminated, together with the reference in the intervention provision to actions brought by the investment company itself. See S. 2224, *supra*, § 22. This legislative history unmistakably suggests that Congress intended for the Commission and security holders to be the sole enforcers of the fiduciary duty imposed on investment advisers by Section 36(b).[8]

b. It is irrelevant for present purposes that a security holder action under Section 36(b) is brought "on behalf of such company." That language indicates that such an action is brought for the company's benefit and that any recovery is to be paid to the company rather than the individual security holder plaintiff.[9] But it does not follow that the company itself is authorized to bring suit. As the Second Circuit recognized, "[t]he [Section 36(b)] action is not, strictly speaking, 'derivative' in the sense of deriving from a right properly asserted by the corpora-

[8] Our position here is consistent with the argument recently made by the Commission in *Herman & MacLean* v. *Huddleston*, No. 81-680 (Jan. 24, 1983), in which the Commission contended that implied rights of action should be recognized under another provision of the securities laws. In that case, we were concerned that if an implied right of action was not recognized there would be no damage remedy for certain misconduct. Here, Section 36(b) expressly affords investors a useful remedy, and no implied action is necessary to make that statute effective.

[9] Furthermore, in the case of an open-end investment company like the Fund in this case, it is largely a legal fiction to state that recovery obtained in a Section 36(b) action is on behalf of the company rather than the security holders. An open-end investment company issues securities redeemable at a price calculated as a pro rata portion of the current net asset value of the company. See Sections 2(a)(32) and 5(a)(1) of the Act, 15 U.S.C. 80a-2(a)(32) and 80a-5(a)(1). Any increase in this net asset value as a result of a favorable judgment would automatically be reflected in the redemption price of the securities. Thus, while recovery in a Section 36(b) suit would initially be paid to the investment company, the company would serve as a conduit for the benefit of holders of redeemable securities.

tion, but rather constitutes individual security holders as 'private attorneys general' to assist in the enforcement of a duty imposed by the statute on investment advisers" (Pet. App. 23a). In other words, security holders who file actions under Section 36(b) act in a capacity similar to that of the Commission when it brings suit under the statute. Since it could hardly be maintained that the Commission must make prelitigation demand, the same should be true for security holders.

The essential difference between a Section 36(b) action and a traditional derivative suit is illustrated by the fact that Section 36(b) authorizes suit, not by "shareholders," but by "security holders." This choice of broader terminology was obviously deliberate in view of Congress's use of the word "shareholder" in Section 36(b)(2). The class of potential plaintiffs under Section 36(b) thus includes holders of debt instruments issued by an investment company.[10] By contrast, it is well settled that traditional derivative actions may be brought only by equity holders. See 3B J. Moore & J. Kennedy, *Moore's Federal Practice* ¶ 23.1.17, at 23.1-68 to 23.1-69 (2d ed. 1982) and cases cited therein; 7A C. Wright & A. Miller, *Federal Practice and Procedure* § 1826 (1972 & Pocket Part 1982). Unlike creditors, equity shareholders are deemed to possess the corporation's residual managerial authority and may consequently protect the corporation's interests when management fails or refuses to do so. See *Ashwander* v. *Tennessee Valley Authority*, 297 U.S. 288, 321 (1936); *Kauffman* v. *Dreyfus Fund, Inc.*, 434 F.2d 727, 735-736 (3d Cir. 1970); 13 W. Fletcher, *Fletcher Cyclopedia Corporations* § 5972.2, at 455 (Perm. ed. 1980). Thus, a security holder suit under Section 36(b) is not one in which persons who may be said to own part of the invest-

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[10] Examples of registered investment companies that may issue debt instruments include closed-end companies and face-amount certificate companies. See Sections 2(a)(15) and 18 of the Act, 15 U.S.C. 80a-2(a)(15) and 80a-18. The Commission's most recent report to Congress indicates a total of 170 registered closed-end investment companies. 1982 SEC Ann. Rep. 95.

ment company are permitted to assert a claim belonging to their company. Rather, it is a suit in which members of a broader group, including creditors, may assert an independent cause of action.[11]

3. *A demand requirement in Section 36(b) actions would serve no meaningful purpose and would frustrate full recovery*

While serving a legitimate purpose in traditional derivative suits, a demand requirement would be of little value in Section 36(b) actions and would frustrate full recovery.

a. In traditional derivative actions, the demand requirement is premised upon the view that corporate management should be afforded the initial opportunity to pro-

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[11] Petitioners (Br. 8) and amicus (Investment Company Institute Br. 7, 19-20) argue that the Commission acknowledged the applicability of the demand requirement in stating to Congress that the Federal Rules of Civil Procedure provide adequate safeguards against strike suits brought under Section 36(b). Petitioners cite (Br. 8) a footnote to Commission Chairman Budge's oral statement in House Hearings referring to the class action protections in Rule 23. They err, however, in assuming that Chairman Budge actually intended to refer to Rule 23.1 when in fact it seems clear that he meant precisely what he said when he referred to Rule 23, Fed. R. Civ. P. The security holder action under Section 36(b) may be viewed as a class action maintainable under Rule 23(b)(1)(B). See Fed. R. Civ. P. 23, Advisory Committee Note to 1966 Amendment and cases cited therein. The principal protection against strike suits in the class action rule is the requirement of judicial approval of settlements; there are no provisions relating to demand in Rule 23.

Even if Chairman Budge had meant Rule 23.1, the chief protection against strike suits found in Rule 23.1, as in Rule 23, is the requirement of court approval of settlements. 7A C. Wright & A. Miller, *Federal Practice and Procedure* § 1839, at 427-428 (1972). Clearly Rule 23.1's *pleading* requirements concerning demand are not designed to deter strike suits. And contrary to petitioners' contention (Br. 17-18), the demand requirement itself has not generally been recognized as a deterrent to strike suits, although it may have that incidental effect. Instead, as we have noted, its main purpose is to give the corporation an opportunity to vindicate its own rights.

tect the corporation's rights and that shareholders should be permitted to sue on the corporation's behalf only where management is unwilling or unable to take proper action. *United Copper Securities Co.* v. *Amalgamated Copper Co.*, *supra*, 244 U.S. at 263-264; *Delaware & Hudson Co.* v. *Albany & S. R.R.*, *supra*, 213 U.S. at 446-447. Prelitigation demand affords the directors an opportunity to consider, in the exercise of their business judgment, whether to ratify the transaction or to have the corporation prosecute the action. *Brody* v. *Chemical Bank*, 517 F.2d 932, 934 (2d Cir. 1975). Two other purposes of demand have been suggested. One is that a prelitigation demand on directors provides corporate management with an advance opportunity to evaluate whether, if it rejects demand as not in the best interests of the corporation, the corporation should seek to preclude prosecution of the cause of action by the shareholder. See *Stadin* v. *Union Electric Co.*, 309 F.2d 912, 921-922 (8th Cir. 1962), cert. denied, 373 U.S. 915 (1963); *Swanson* v. *Traer*, 249 F.2d 854, 858 (7th Cir. 1957). A second is that a demand on directors will stimulate extra-judicial resolution of intracorporate disputes, thereby avoiding litigation.

Insofar as demand is intended to allow the corporation to bring its own action, that purpose has no application here since, as we have shown, there is no corporate cause of action under Section 36(b). The other purposes of demand would likewise not be served here.

First, the disinterested directors of an investment company are required by statute to pass upon the fairness of all advisory fee contracts. Under the Investment Company Act of 1940, the advisory contract and any renewal of the contract must be approved by a majority of the disinterested directors, and prior to approval the directors are expressly required to request and evaluate information concerning the fairness of the contract. See Section 15(c), 15 U.S.C. 80a-15(c). In addition, if that contract continues in effect for more than two years, it must be renewed annually by the board of directors or by a majority vote of security holders. See Section 15(a)(2), 15 U.S.C.

80a-15(a)(2). If the directors find that an advisory fee contract is unfair, they are obligated to take appropriate action, which could include modification or termination of the advisory contract. See Section 15(a)(3), 15 U.S.C. 80a-15(a)(3). Given these statutory duties imposed upon the directors, prelitigation demand is not needed to bring to their attention possible inequities in advisory fee agreements. In virtually all instances, such demand would only inform them of matters they had previously considered and approved.

Second, in Section 36(b) suits, directors lack their usual authority to ratify challenged corporate actions and thereby restrict the scope of judicial review. Section 36(b)(2) instructs courts to give director approval of advisory fee contracts only such consideration as the court determines to be appropriate,[12] and the legislative history of this provision shows that Congress intended such approval to be given restricted weight. The Senate first rejected an investment company industry proposal requiring courts to defer to the business judgment of the disinterested directors in approving the advisory fee contract in the absence of "clear and convincing evidence that the * * * directors * * * [had] abuse[d their] business judgment." *1967 S. Hearings, supra*, at 101. Under a later version of the bill, courts were directed to give "substantial" weight to board of director determinations concerning the reasonableness of such fees. The courts were likewise instructed that shareholder ratification or approval was entitled to appropriate consideration in light of all the circumstances. Furthermore, if both the shareholders

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[12] As the Commission made clear in a memorandum submitted during House hearings following Senate passage of Section 36(b), "[t]he adoption of this [fiduciary duty] standard [in Section 36(b)] precludes the assertion of a claim of ratification." *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., Pt. 1, 188 (1969). See also *id.* at 138, 177.

and disinterested directors approved the contract, it was presumed to be reasonable. S. 3724, 90th Cong., 2d Sess. § 8(d)(1) (1968). The statute finally enacted, however, rejected these provisions. As previously noted, the Senate Report emphasized that the directors' judgment "would not be controlling in determining whether or not the fee encompassed a breach of fiduciary duty." S. Rep. No. 91-184, *supra*, at 15. See also *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., Pt. 1, 177 (1969).

The third reason why prelitigation demand would be of little value in Section 36(b) suits is that directors may not seek termination of such actions. A corporation may sometimes attempt to block a traditional derivative action if, in the business judgment of its directors, prosecution of the claim is not in the best interests of the corporation. *Burks* v. *Lasker*, *supra*, 441 U.S. at 485. But this Court in *Burks* (441 U.S. at 484) distinguished the Section 36(b) action as an exception to this general rule, since Section 36(b)(2) expressly limits the weight to be accorded director approval of the advisory contract. Accord, J.A. 46a; *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 939. See also *Grossman* v. *Johnson*, *supra*, 674 F.2d at 121.

In an effort to show that prelitigation demand would serve *some* purpose in Section 36(b) actions, petitioners claim (Br. 17-18) that it might spur the investment company to settle the claim out of court and thus avoid litigation. This argument will not bear analysis. We do not doubt that prelitigation demand may sometimes lead to settlement when a traditional derivative action is contemplated. In that situation, demand may bring to management's attention claims of which it was previously unaware or that it did not fully appreciate. And since the corporation can itself assert those claims in court and can often marshal considerable litigative resources, it can

effectively negotiate with prospective defendants. By contrast, in the case of a Section 36(b) security holder action, demand will not alert the directors to any new claims, since the disinterested directors are required by statute to evaluate the reasonableness of and to approve all advisory fee agreements. And since the company cannot bring suit under Section 36(b), its bargaining power in settlement negotiations is unlikely to exceed that of a security holder, who can sue but will usually have a strong incentive to avoid costly litigation if possible. In short, it is difficult to see how prelitigation demand would aid in the settlement of prospective Section 36(b) suits.

b. Requiring prelitigation demand in Section 36(b) actions would also be inconsistent with Section 36(b)(3), which limits recovery to actual damages suffered beginning one year before commencement of the action.[13] A prelitigation demand requirement would cause delay while the directors evaluated the claim,[14] thereby permitting months of potentially exorbitant fees to pass beyond the court's reach. Similarly, if a security holder filed suit without complying with the demand requirement on the asserted ground that it was excused in the particular circumstances of the case, resolution of the adequacy of the excuse would engender delay, thereby immunizing exces-

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[13] The one-year statute of limitations in Section 36(b) contrasts sharply with the three to six year statutes of limitations applicable to State law claims of corporate waste. See Cal. Civ. Proc. Code § 343 (West 1982) (4 years); Del. Code Ann. tit. 10, § 8106 (1975) (3 years); Md. Cts. & Jud. Proc. Code Ann. § 5-101 (1980) (3 years); Mass. Ann. Laws ch. 260, § 2 (Michie/Law. Coop. 1980) (6 years); N.Y. Civ. Prac. Law & R. § 213 (McKinney 1972) (6 years).

[14] See Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b) (where Congress selected 60 days as a reasonable time for corporate response to security holder demand in actions for recovery of short-swing profits from certain insiders); *Mills* v. *Esmark, Inc.*, 91 F.R.D. 70, 73 (N.D. Ill. 1981) (where 3½ months was deemed a reasonable time for corporate response).

sive fees from recovery if the excuse question is resolved adversely to the plaintiff. To understand what even a relatively short delay might mean, it should be noted that in 1981 petitioner R&T earned fees of approximately $4 million, which amounts to $333,333 per month.

Both the First and Third Circuits addressed this issue, but their analysis, which petitioners approvingly cite (Br. 25-26), is flawed. The First Circuit reasoned (*Grossman v. Johnson*, *supra*, 674 F.2d at 122) that delay might "change the particular one-year period for which recovery was allowable but would not reduce the one-year recovery period, and probably not decrease the amount." The Third Circuit adopted similar reasoning (*Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 938). Not only does this reasoning presuppose an unvarying fee based upon services rendered and expenses incurred—and that is not always the case—but it overlooks the fact that the date from which the computation of any recovery begins matters very much. Suppose, for example, that an advisory fee is unvarying and that demand delays the filing of suit by two months. While the security holder (and thus the company) may recover the same amount in the lawsuit, *i.e.*, the excessive fees charged beginning one year prior to the filing of suit, the company will have been charged excessive fees for two more months, and that amount could never be recouped.[15]

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[15] In view of the holding below that the demand requirement is not applicable to a Section 36(b) action, the court of appeals reserved judgment on the issue of whether demand should have been excused because of the directors' prior participation in fixing the amount of the advisory fee (J.A. 27a n.4). Even under the strict self-interest or bias test employed by the First and Third Circuits (see *Lewis* v. *Curtis*, 671 F.2d 779, 787 (3d Cir. 1982), cert. denied, No. 81-2224 (Oct. 4, 1982); *Heit* v. *Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977)), demand should be excused where a majority of the incumbent disinterested directors have previously approved the advisory fee contract. Since those directors have a duty under Section 15(c) of the Act to evaluate the fairness of the adviser's compensation, a conclusion that such compensation is excessive may subject them to financial liability and other sanctions under Section

II. IF PRELITIGATION DEMAND IS REQUIRED IN SECTION 36(b) ACTIONS, A SECURITY HOLDER SHOULD NOT BE PREVENTED FROM INSTITUTING OR MAINTAINING SUIT IF THE DIRECTORS REJECT THE DEMAND

Should this Court require demand in actions under Section 36(b), we urge the Court to make clear that the demand requirement will not carry with it the limitations usually placed on derivative suit plaintiffs following rejection of demand. Security holders should not be subjected to the obligation of showing that rejection of demand was wrongful or of resisting motions to terminate actions on the basis of the business judgment rule. Congress's determination to permit judicial review of the fairness of advisory fees would be undermined if such restrictions were imposed.[16]

The consequences of the demand requirement in ordinary derivative suits are well known. A board of directors' determination on "[w]hether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors * * *." *United Copper Securities Co.* v. *Amalgamated Copper Co., supra,* 244 U.S. at 263. See *Corbus* v. *Alaska Treadwell Gold Mining Co.,* 187 U.S. 455,

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36(a) of the Act for personal misconduct in connection with a breach of their duties under Section 15(c). Their self-interest in avoiding such possible consequences should ordinarily excuse demand.

[16] While we previously argued (see page 24, *supra*) that the prohibition against business judgment termination of Section 36(b) actions removes a policy justification for the demand requirement, the question whether demand is required in the first instance is distinct from the question whether a security holder may pursue a claim following rejection of demand. Thus, should the Court disagree with our argument that demand is not required in Section 36(b) actions, that holding should not control the separate question whether, following rejection of demand, a security holder may still pursue a Section 36(b) claim.

463 (1903); *Ashwander* v. *Tennessee Valley Authority*, *supra*, 297 U.S. at 343 (Brandeis, J., concurring). Where demand is required, courts usually interfere only if the corporation's refusal to pursue a valid claim is "wrongful." See Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 191-200 (1976). Even where demand is excused, a corporation may subsequently terminate the action if, in the directors' business judgment, it is not in the corporation's best interests. *Burks* v. *Lasker*, *supra*, 441 U.S. at 485.

By contrast, in *Burks* v. *Lasker*, *supra*, 441 U.S. at 484, this Court observed that corporations may not terminate Section 36(b) actions on the basis of the directors' business judgment. The Court was there invoking Section 36(b)(2), which expressly limits the weight to be accorded director approval of advisory fees. Consistent with this provision, the demand requirement should not operate to bar prosecution of a Section 36(b) claim by a security holder willing to undertake the costs of litigation. To be sure, Section 36(b)(2) by its terms does not deal with the directors' decisions about the prosecution of litigation concerning advisory fees. But since that provision instructs courts not to defer to directors' decisions regarding the reasonableness of the fees themselves, it would be wholly inconsistent if directors could preclude litigation challenging those very fees.

Imposing such restrictions would also create an unwarranted distinction between security holder actions under Section 36(b) and those initiated by the Commission under the same provision. Clearly, neither the demand requirement nor the business judgment rule have force in a Commission action, and the statute draws no distinctions between the two suits. It was for this reason that the court of appeals below concluded (J.A. 33a) that the security holder who brings suit under Section 36(b) acts as a private attorney general. Placing special restrictions upon security holder actions would distort the statutory

scheme in a way that would place a greater enforcement burden on the Commission. Such a result would be contrary to the carefully fashioned congressional scheme under which the private action is the primary vehicle for remedying abuses involving investment advisory fees.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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v.
Martin Fox

Docketed:
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Court: United States Court of Appeals for the Second Circuit

Counsel for petitioner: Pollack, Daniel A.

Counsel for respondent: Meyer, Richard M., Solicitor General

Entry	Date	Note	Proceedings and Orders
1	Jan 17 1983	G	Petition for writ of certiorari filed.
2	Feb 8 1983		Brief of respondent Martin Fox in opposition filed.
3	Feb 9 1983		DISTRIBUTED. February 25, 1983
6	Feb 28 1983		DISTRIBUTED. March 4, 1983
7	Mar 7 1983		Petition GRANTED.
			**
10	Apr 21 1983		Brief of petitioners Daily Income Fund, Inc. filed.
11	Apr 21 1983		Joint appendix filed.
12	Apr 21 1983	G	Motion of Investment Company Institute for leave to file a brief as amicus curiae filed.
13	Apr 25 1983		Record filed.
14	Apr 25 1983		Certified original record & C.A. proceedings received.
15	May 16 1983		Motion of Investment Company Institute for leave to file a brief as amicus curiae GRANTED.
16	May 19 1983		Brief amicus curiae of Securities and Exchange Commission filed.
17	May 23 1983		Brief of respondent filed.
18	Jul 8 1983		CIRCULATED.
19	Sep 21 1983		SET FOR ARGUMENT. Monday, November 7, 1983. (2nd case) (1 hour)
20	Oct 21 1983	X	Reply brief of Daily Income Fund, Inc., et al. filed.
21	Nov 7 1983		ARGUED.